CANADA MORTGAGE AND HOUSING CORPORATION

THE TAXATION OF RESIDENTIAL PROPERTY IN CANADA

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THE TAXATION OF RESIDENTIAL PROPERTY IN CANADA

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1 Introduction

The system of taxation in Canada has become increasingly complex over the past several decades. In an effort to stop perceived abuses of tax incentives, the federal government has continued to introduce rules that treat different types of taxpayers differently. For example, to provide an incentive to invest in new property and equipment, some capital cost allowance (CCA) rates are generally higher than the rate of economic decline would imply. However, since this provides an incentive in certain real estate contexts that are viewed by some to be undesirable, claiming CCA cannot create losses for some taxpayers.

Competing with the tax objective of targeting tax incentives is the objective of tax neutrality or fairness. Tax neutrality would require that taxpayers engaged in the same economic activity would be taxed similarly. Stated another way, specific tax provisions will not influence economic decisions, such as to purchase versus rent housing or to operate as a corporation whose principal business is rental housing (often referred to as a principal business corporation, or PBC), versus a corporation engaging in other activities.

The following research report sets out and explains tax provision relating to housing providers, owners and renters. In addition, an overview of further research that could be conducted to evaluate these tax rules is provided.

1.1 Overview of Research Issue

Taxation is pervasive in the Canadian economy. Taxes include federal, provincial and municipal, or local, taxes. The federal government levies personal and corporate income taxes, other corporate taxes like payroll and capital taxes, a value-added tax (the Goods and Services Tax), and excise taxes. The provincial governments also collect personal and corporate income taxes, but generally follow the rules set out by the federal government. Provincial governments also levy sales taxes or participate in the federal value-added tax and collect taxes such as land transfer taxes. Local governments generally only collect property taxes and certain fees.

The magnitude of taxes varies; in 1995, at all levels of government personal income taxes accounted for $105 billion; payroll and capital taxes, $50 billion; sales and value-added taxes, $43 billion; property taxes, $29 billion; and corporate income tax, $19 billion. All other taxes

and levies account for the remaining $37 billion of total government tax revenues in Canada. [Source: *Report of the Technical Committee on Business Taxation*, 1997]

1.2 Structure of the Report

Many of these taxes affect the production, ownership and use of housing, and decisions surrounding these functions. For the purpose of this report, taxation will be segmented into three main categories. Section 2 presents the taxation of producers of housing (e.g., home builders and multiple-unit residential builders). Section 3 identifies the taxation of owners of rental housing (e.g., corporations — both principal business corporations and not, real estate investment trusts, and individuals). Finally, section 4 discusses the taxation of the occupant individuals of owned and rented housing. Thus, for example, various corporate income tax provisions will be explored as part of sections 2 and 3 while personal income tax provisions will have greatest effect in sections 3 and 4. Section 5 summarizes the criteria, methodology, and possible research questions that could be explored, with particular focus on the taxation of the providers of rental housing, as described in section 3.

By presenting the tax provisions by economic function, rather than by taxation type, the focus will be comparisons across alternative forms that these economic activities take, as well as providing a better framework to analyze the impact of the tax provisions on housing-related economic activities.

2 Taxation on Producers of Housing

2.1 Overview

In the analyses of taxes that follow, it will be assumed that producers of housing, both single and multiple-unit housing, are generally corporations that are actively engaged in this form of commercial activity. Therefore, the basic analyses will be for corporations which generate business income by producing residential properties that may be sold upon completion (businesses that will be referred to as "builder-sellers") or may be rented out by the builder (businesses that will be referred to as "builder-renters").

The most common form of organizational/ownership structure for this type of business is a Canadian-controlled private corporation (CCPC). Thus, much of the analysis will focus on the tax provisions that are applicable to this type of entity. Other forms of ownership might be foreign-controlled corporations or Canadian public corporations. While less prevalent, rules applicable to these entities that differ from those related to CCPCs will be identified in the appropriate sections. It is possible that some builders conduct their business in an unincorporated form. This would seem to be rare and so will not be discussed directly in this section of the report.

Many taxes are applicable to the corporations that produce housing in Canada. Income taxes levied on the corporations are likely the most significant component of these taxes. In Canada, the Federal Government legislates and administers the federal income tax system through the *Income Tax Act*[1] and its regulations. In addition, the Canada Customs and Revenue Agency (CCRA) provides guidance to taxpayers on its interpretation and administration of the income tax system through a series of Interpretation Bulletins and Information Circulars, among other published materials. Provinces generally follow the tax provisions set out in the Act and most have signed collection agreements with the federal government that require the provincial statutes to follow the federal one; however, Alberta, Ontario and Quebec do not have such collection agreements and have, at least, the power to

[1] The Income Tax Act, RSC 1985, C. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this report are to the Act.

introduce their own tax rules. To date, Quebec has been the only province that has developed a taxation system that differs significantly from the federal one.

A value added taxation system (the Goods and Services Tax, or GST) also applies to commercial activity conducted in Canada. All active builders are assumed to be GST registrants because any "person" (which includes corporations) engaged in commercial activity with gross revenues in excess of $30,000 per year must register.

New Brunswick, Nova Scotia and Newfoundland have joined with the federal government in the value added tax system, which in these provinces is called the Harmonized Sales Tax (HST) system. From the perspective of the registrant, there are no differences in the rules under GST or HST, simply a difference in rates. All provinces not part of the HST system, except Alberta, levy a provincial sales tax. Sales taxes are designed to be taxes on consumers and, so, many businesses are exempt from paying retail sales tax on many of their inputs.

2.2 Federal Corporate Income Taxes in Canada

2.2.1 General rules and rates

For federal tax purposes, income is divided into several types within Part I, Division B of the Act. Income generated by individuals and corporations that engage in the construction and/or rental of residential property would either be classified as business income or property income. The rules applicable to these two types of income are the same in general, and are both contained in Part I, Division B, subdivision b of the Act. For example, receipts for both business and property are included in income under subsection 9(1) as follows.

> 9(1) Subject to this part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.

In some cases, however, there is a distinction that is made between business income and property income. Where these are important, they will be discussed in detail as appropriate below.

While the concept of income is not defined within the Act, sections 9 through 17 provide details of specific inclusions for the computation of business and property income and sections 18 through 21 provide details of specifically allowed and prohibited deductions in the computation of income from business and property.

The rate at which income tax is collected from corporations by the federal government in Canada is 38% (section 123). However, this rate is subject to modification, depending on the type of corporation, by provisions such as those in sections 123.2 through 127. Section 123.2, which levies a surtax on corporations; section 124, which provides an abatement of 10% for income earned in a province or territory as consideration for provincial taxes levied; and according to the government's February 2000 Budget a new rate reduction of 1% beginning in 2001, are generally applicable to all corporations. Thus, for a typical corporation, before any special rate reductions that might be available, the federal income tax rate is as follows

Basic federal tax rate	38.00%
Federal abatement for provincial taxes	(10.00)
Net federal tax	28.00%
Tax rate reduction for 2001	(1.00)
Federal surtax @4% of net federal tax for 2001	1.12
Total federal tax	28.12%

The tax rate reduction for 2001 is the first change since 1996, prior to which the rate was 28.84%. The announced reduction for 2001 represents the first of a series of reductions aimed at reducing the corporate rate to 22.12% by 2004.

In addition to the Part I tax on the taxable income of corporations, Part I.3 of the Act provides for a Tax on Large Corporations (LCT) which is, in effect, a corporate alternative minimum tax. It is levied at a rate of 0.225% of capital in excess of $10 million employed in Canada (subsections 181.1(1) and 181.5(1)). Taxable capital employed in Canada is computed for non-financial corporations, generally, as the sum of share capital and debt that is outstanding for more than 365 days, less an allowance for investments in other corporations (which consist of shares of, loans and advances to, and dividends receivable from other corporations). The amounts are computed using the unconsolidated financial statements.

Part I.3 tax is then reduced by the amount of the Canadian surtax, which is the federal surtax that can be attributed to a permanent establishment in Canada. The LCT for the corporation's current taxation year is further reduced by the excess of past Canadian surtax over LCT during any previous carry-over year. Thus, surtax in excess of LCT can be carried back for three years or forward for seven years to reduce net LCT in those years (subsection 181.1(4)).

Example application of Part I tax and Part I.3 tax.

ABC Corporation, a public corporation in the business of owning and renting apartment buildings of 100 units or more, had the following balance sheet as at December 31, 2001:

	($ 000's)
Current assets	20,000
Investment in Little Corp.	10,000
Loan receivable from Cash Poor Limited	15,000
Fixed assets, net of $260 million of accumulated depreciation	300,000
Goodwill, net of $30 million of amortization	55,000
Total assets	400,000
Accounts payable	25,000
Income tax payable	5,000
Dividends payable	10,000
Total current liabilities	40,000
Mortgage payable	160,000
Future income taxes	40,000
Contingent liability (re: lawsuit)	10,000
Common shares	100,000
Retained earnings	50,000
Total equity	150,000
Total liabilities and equity	400,000

Note: the investment in Little Corp. represents 100% of its common shares and is accounted for at cost.

ABC's taxable income for its taxation year ending December 31, 2001, was $30 million and 100% of its taxable income was earned in a province.

Calculation of Part I tax:

	($ 000's)
Basic federal tax (38% of $30 million)	11,400
Federal abatement for provincial taxes (10% of $30)	(3,000)
Net federal tax	8,400
Tax rate reduction (1% of $30 million)	(300)
Federal surtax @4% of net federal tax	336
Total federal tax	8,436

Calculation of Part I.3 tax:

		($ 000's)
Capital:		
Capital stock [par. 181.2(3)(*a*)]	100,000	
Retained earnings [par. 181.2(3)(*a*)]	50,000	
Mortgages payable [par 181.2(3)(*d*)]	160,000	
Dividends payable [par 181.2(3)(*e*)]	10,000	
Future income taxes [par. 181.2(3)(*b*)]	40,000	
Contingency [par 181.2(3)(*b*)]	10,000	
Total capital		370,000
Less: investment allowance [subsec 181.2(4)]:		
Investment in Little Corp	10,000	
Loan receivable from Cash Poor Limited	15,000	
Total investment allowance		25,000
Taxable capital		345,000
Taxable capital employed in Canada (100%)		345,000
Less: capital deduction applicable to all corporations		10,000
Amount subject to Part I.3 tax		335,000
Part I.3 tax at 0.225%		754 (A)
Surtax for the year (from above)		336
Canadian surtax for the year (100%)		336 (B)
Part I.3 tax liability after credit for Canadian surtax (A – B)		418

2.2.2 Special rate reductions available

There are two major rate reductions allowed to corporations in Canada: the small business deduction under section 125, and the manufacturing and processing deduction under section 125.1. However, the definition of manufacturing or processing in subsection 125.1(3) explicitly excludes construction (paragraph (*c*) of the definition of "manufacturing or processing").

The small business deduction represents a credit against the tax otherwise payable on income "from an active business carried on in Canada" and is designed for only small CCPCs in order to assist them to retain capital to expand their businesses. Note, however, that the corporation does not have to be "small" in order to qualify for the credit. The small business deduction provides a credit of 16% on the first $200,000 of qualifying taxable income (subsection 125(2)) and credit of 7% for income between $200,000 and $300,000. Further elaboration of administrative practice on the application of this deduction is provided in Interpretation Bulletin *IT-73R5 The Small Business Deduction* (February 5, 1997). Thus, for this income, the federal rate is 13.12% (29.12% presented above, less 16%) for the first $200,000, then 22.12% for the income greater than $200,000 and less than $300,000.

For large CCPCs, the small business deduction is phased out with a formula based on the amount of taxable capital employed in Canada for purposes of the LCT for the preceding taxation year. The phase-out range is taxable capital employed in Canada between $10 million and $15 million and the small business deduction is phased out linearly over this range (subsection 125(5.1)). For example, if the corporation presented in the example in section 2.2.1 were a CCPC, it would not qualify for the small business deduction since its taxable capital employed in Canada is $345 million.

Another important feature of the small business deduction is that it applies to active business only. Subsection 125(7) defines active business income as follows:

> "active business carried on by a corporation" means any business carried on by the corporation other than a specified investment business or a personal services business and includes an adventure or concern in the nature of trade.

A "specified investment business" is defined in subsection 125(7) to mean

> "specified investment business" carried on by a corporation in a taxation year means a business (other than a business carried on by a credit union or a business of leasing property other than real property) the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property but, except where the corporation was a prescribed labour-sponsored venture capital corporation at any time in the year, does not include a business carried on by the corporation in the year where
>
> (*a*) the corporation employs in the business throughout the year more than 5 full-time employees, or
>
> (*b*) any other corporation associated with the corporation provides, in the course of carrying on an active business, managerial, administrative, financial, maintenance or other similar services to the corporation in the year and the corporation could reasonably be expected to require more than 5 full-time employees if those services had not been provided;

Thus, the business of constructing residential property would be considered to be active business; however, the business of renting residential property would not if the business did not employ more than five full-time employees or did not have an associated corporation performing these services, as described in paragraph (*b*) of the definition above. The courts (*The Queen v. Hughes & Co. Holdings Ltd.*, (FCTD) 94 DTC 6511) have held that this means at least six full-time employees and part-time employees are not included in the calculation.

The effects of these rules are to allow the small business deduction to companies on income generated by the construction of residential real estate, so long as the corporation otherwise qualifies (i.e., is a CCPC that does not exceed the size restrictions). However, a

subtle aspect of the definition is that income generated through the rental of residential property does not qualify for the rate reduction unless the company employs more than five full-time employees in the rental *business* (note that having a construction division, or another division, that employs more than five full-time employees is not sufficient, the *rental* division must employ the individuals—a corporation can carry on more than one business).

2.2.3 Capitalization of land carrying costs

The deduction of carrying charges (i.e., interest and property taxes) in respect of vacant land, which is not used to produce income from holding it, is limited by subsections 18(2) and (3). There is an exception to this rule where the land can reasonably be considered to be used or held in the carrying on of business (excluding the unincorporated business of selling or developing land) or held primarily for the purpose of gaining or producing income from the land. This treatment does not apply to a building and the land on which it is situated or adjoining land used in connection with the building. Thus, the treatment only applies to vacant, essentially idle, land.

For land subject to this limitation, interest and property taxes can only be deducted to the extent that gross revenues exceed all other expenses. If the land is regarded as a capital asset, the non-deductible part of the interest and property taxes can be added to the cost base of the land under paragraph 53(1)(*h*) in the computation of cost for capital gains purposes. If the land is regarded as inventory, the non-deductible cost can be added to the cost of the inventory under subsection 10(1.1).

Subsections 18(2) and (3) are as follows:

> 18(2) Notwithstanding paragraph 20(1)(*c*), in computing the taxpayer's income for a particular taxation year from a business or property, no amount shall be deductible in respect of any expense incurred by the taxpayer in the year as, on account or in lieu of payment of, or in satisfaction of,
>
> (*a*) interest on debt relating to the acquisition of land, or
>
> (*b*) property taxes (not including income or profits taxes or taxes computed by reference to the transfer of property) paid or payable by the taxpayer in respect of land to a province or to a Canadian municipality,
>
> unless, having regard to all the circumstances (including the cost to the taxpayer of the land in relation to the taxpayer's gross revenue, if any, from the land for the particular year or any preceding taxation year), the land can reasonably be considered to have been, in the year,
>
> (*c*) used in the course of a business carried on in the particular year by the taxpayer, other than a business in the ordinary course of which land is held primarily for the purpose of resale or development, or

(*d*) held primarily for the purpose of gaining or producing income of the taxpayer from the land for the particular year,

except to the extent of the total of

(*e*) the amount, if any, by which the taxpayer's gross revenue, if any, from the land for the particular year exceeds the total of all amounts deducted in computing the taxpayer's income from the land for the year, and

(*f*) in the case of a corporation whose principal business is the leasing, rental or sale, or the development for lease, rental or sale, or any combination thereof, of real property owned by it, to or for a person with whom the corporation is dealing at arm's length, the corporation's base level deduction for the particular year.

(3) In subsection (2),

"interest on debt relating to the acquisition of land" includes

(*a*) interest paid or payable in a year in respect of borrowed money that cannot be identified with particular land but that may nonetheless reasonably be considered (having regard to all the circumstances) as interest on borrowed money used in respect of or for the acquisition of land, and

(*b*) interest paid or payable in the year by a taxpayer in respect of borrowed money that may reasonably be considered (having regard to all the circumstances) to have been used to assist, directly or indirectly,

(i) another person with whom the taxpayer does not deal at arm's length,

(ii) a corporation of which the taxpayer is a specified shareholder, or

(iii) a partnership of which the taxpayer's share of any income or loss is 10% or more,

to acquire land to be used or held by that person, corporation or partnership otherwise than as described in paragraph (2)(*c*) or (*d*), except where the assistance is in the form of a loan to that person, corporation or partnership and a reasonable rate of interest on the loan is charged by the taxpayer;

"land" does not, except to the extent that it is used for the provision of parking facilities for a fee or charge, include

(*a*) any property that is a building or other structure affixed to land,

(*b*) the land subjacent to any property described in paragraph (*a*), or

(*c*) such land immediately contiguous to the land described in paragraph (*b*) that is a parking area, driveway, yard, garden or similar land as is necessary for the use of any property described in paragraph (*a*).

The following example illustrates the use of these rules.

Example application of deductibility limitation on land carrying charges.

In 1998, Mr. B acquired a vacant lot in a downtown area of the city, intending to build an office complex. By mid 2000 he decided to abandon the project. The property was disposed of in June. It was *not* considered to have been held for speculation because of the unforeseen problems encountered in the development.

While Mr. B owned the property, it had been used as a city parking lot with the following results:

	1998	1999	2000
Net income (loss) before interest and property tax	$11,000	$ 6,000	($ 3,000)
Interest and property taxes	9,500	10,000	5,250

Application of the rules:

Since the land, held for development in this case, is not excluded from the limitation in subsection 18(2), interest and property taxes will be deductible only to the extent of gross revenues in excess of all other expenses, i.e., net income before interest and property taxes. As a result, the following amount would be reported as income for the years indicated:

	1998	1999	2000
Net income (loss) before interest and property tax	$11,000	$ 6,000	($ 3,000)
Less: interest and property taxes	9,500	6,000	Nil
Income (loss) for the year	$ 1,500	Nil	($ 3,000)
Non-deductible interest and property taxes added to adjusted cost base of land	Nil	$ 4,000	$ 5,250

Note that if the sale of the land had given rise to business income because it was considered to be a concern or adventure in the nature of trade, then the non-deductible interest and property taxes would be added to the inventoried cost value of the land.

The limitation described above extends to land held primarily for resale or development; however, corporations whose principal business is leasing, rental or sale, and the development for leasing, rental or sale, of real property (sometimes referred to as "principal business corporations," or PBCs) are permitted to deduct all carrying charges on the vacant land (see the exception found in paragraph 18(2)(*f*) presented above). The definition and application of the PBC provisions is presented in section 3.2.3, below. Most corporations that construct residential property, would likely be considered to fall within the definition of a PBC, and so would not be under the general limitation of 18(2).

For corporations that are not limited by subsection 18(2) due to the exception for PBCs in paragraph 18(2)(*f*), the amount of interest and property taxes that is deductible is limited to the interest that would be paid at the prescribed rate (i.e., that found in the *Income Tax Regulations*) on a loan of $1,000,000 outstanding throughout the year (as described in subsection 18(2.2)). Where the corporation is part of an associated group of corporation, the limitation must be shared. The $1,000,000 amount has not been changed since its introduction in 1981, making the limitation more constraining as inflation decreases the value of the limit.

Example application of deductibility limitation on land carrying charges for a PBC.

Reconsider the case of Mr. B presented previously, but the assumption that the land was owned by a corporation whose principal business was the development and sale of land is made. If the prescribed rate of interest is 8% throughout the period, the amount of interest and property tax is limited to $80,000 per year. The corporation would report the following losses:

	1998	1999	2000
Net income (loss) before interest and property tax	$11,000	$ 6,000	($ 3,000)
Less: lesser of			
(a) interest and property taxes	$ 9,500	$10,000	$ 5,250
(b) base level deduction	$80,000	$80,000	$80,000
lesser amount	(9,500)	(10,000)	(5,250)
Income (loss) for the year	$ 1,500	($ 4,000)	($ 2,250)

These losses are of immediate value to the corporation only if it has other income against which to deduct the losses; otherwise, they are available to be carried back 3 years or forward 7 years.

2.2.4 Rules applicable to builder-sellers

Builder-sellers are corporations (usually) that are in the business of constructing single or multiple family units. Upon completion, these are sold to others who will either occupy them as owners, or will rent them to others. Since the company is in the business of building and selling buildings, the buildings it constructs are treated as inventory (similar to any other manufacturer). Therefore, costs of constructing the properties are generally included in the inventory cost of the building and expensed to match the proceeds received. Property taxes, for example, are regarded as a cost of the property and are included in the inventory value. However, interest costs are regarded as a cost of capital and are deducted each period as incurred, rather than being added to the inventory value.

For the builder-seller, where proceeds of disposition are spread out over a number of periods (i.e., an instalment sale), the gross profit on the sale can be reduced by a reserve that is allowed under paragraph 20(1)(*n*). This paragraph is as follows:

> 20(1) Notwithstanding paragraphs 18(1)(*a*), (*b*) and (*h*), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:
>
> ... (*n*) where an amount included in computing the taxpayer's income from the business for the year or for a preceding taxation year in respect of

> property sold in the course of the business is payable to the taxpayer after the end of the year and, except where the property is real property, all or part of the amount was, at the time of the sale, not due until at least 2 years after that time, a reasonable amount as a reserve in respect of such part of the amount as can reasonably be regarded as a portion of the profit from the sale;

This provision allows the seller to defer the income inclusion to match proportionately with the receipt of proceeds, rather than on the accrual method, once several conditions are satisfied (e.g., the reserve is restricted to residents of Canada). However, the duration of this reserve is limited by subsection 20(8) to sales made before 36 months prior to the end of the current taxation year; that is, the deferral is only permitted for up to the end of the third year. Further elaboration of the application of this reserve is provided in Interpretation Bulletin *IT-152R3 Special reserves—Sale of land* (June 18, 1985).

Example application of instalment sale reserve.

L Ltd. bought a parcel of land in 1985. It was its intention to subdivide the land and build a subdivision of homes on the property in the future. However, the city continued to delay issuing permits to L Ltd. and eventually it purchased other lands. L Ltd. held the land for a number of years but has now decided to sell the property. The details relating to the purchase and sale are set out below.

Purchase price: $100,000, purchased May 21, 1985.

Offer of purchase price: $160,000, purchase date October 1, 2000

Payment terms: $40,000 down payment on purchase date; $20,000 payable on January 1 each year for the period January 1, 2001 through January 1, 2006 inclusive.

Interest: interest is payable at 6% annually on the unpaid balance, due with January 1 payments.

Costs of disposition: $10,000

The income from the sale of the property for each year ended December 31 is computed as follows (taking into consideration the availability of the reserve that is allowed under paragraph 20(1)(*n*)):

2000	
Sale proceeds	$ 160,000
Cost ($100,000 + $10,000)	(110,000)
Profit	$ 50,000
Reserve: $50,000 x $120,000/$160,000	(37,500)
Income	$ 12,500
2001	
Prior year's reserve	$ 37,500
Reserve: $50,000 x $100,000/$160,000	(31,250)
Income	$ 6,250

2002	
Prior year's reserve	$ 31,250
Reserve: $50,000 x $80,000/$160,000	(25,000)
Income	$ 6,250
2003	
Prior year's reserve	$ 25,000
Reserve: limited by subsection 20(8)	Nil
Income	$ 25,000

In addition to these amounts, the interest would be included in income each year on an accrual basis.

2.2.5 Rules applicable to builder-renters: Construction soft costs

Builder-renters are corporations (usually) that not only construct residential property, but do so in order to rent the property to others once construction is complete. In this case, costs of constructing the property are considered to be capital costs of the assets ultimately used in the rental business. The issue that arises in this setting is distinguishing between costs that must be capitalized into the asset value from costs that can be expensed in the period of construction. Rules relating to the point in time when the property goes from being "under construction" to being in use are discussed in the following section.

Subsection 18(3.1) requires that expenses attributable to the period of construction, renovation or alteration of a building, or in the respect of the ownership of related land, must be capitalized to the building rather than expensed as may normally be allowed. These "soft costs," if attributable to the period of construction, renovation or alteration, might include, among other items, interest, legal and accounting fees of construction, insurance, and property taxes. Capital cost allowance and landscaping costs (deductible under 20(1)(*aa*)) are exempt from this treatment. Also exempt are disability-related modifications to buildings, which are deductible under 20(1)(*qq*).

Certain interest payments, which otherwise might not be specifically identified with the construction, renovation or alteration of a particular building or the ownership of a particular piece of land, are subject to the capitalization rules as a result of subsection 18(3.2). Thus, for example, where surplus funds are used to pay for construction costs and money is borrowed to finance business operations, a portion of the interest on borrowed funds would have to be capitalized. The basic provisions are as follows.

18(3.1) Notwithstanding any other provision of this Act, in computing a taxpayer's income for a taxation year,

(*a*) no deduction shall be made in respect of any outlay or expense made or incurred by the taxpayer (other than an amount deductible under paragraph 20(1)(*a*), (*aa*) or (*qq*) or subsection 20(29)) that can reasonably be regarded as a cost attributable to the period of the construction, renovation or alteration of a building by or on behalf of the taxpayer, a person with whom the taxpayer does not deal at arm's length, a corporation of which the taxpayer is a specified shareholder or a partnership of which the taxpayer's share of any income or loss is 10% or more and relating to the construction, renovation or alteration, or a cost attributable to that period and relating to the ownership during that period of land

(i) that is subjacent to the building, or

(ii) that

(A) is immediately contiguous to the land subjacent to the building,

(B) is used, or is intended to be used, for a parking area, driveway, yard, garden or any other similar use, and

(C) is necessary for the use or intended use of the building; and

(*b*) the amount of such an outlay or expense shall be included in computing the cost or capital cost, as the case may be, of the building to the taxpayer, to the person with whom the taxpayer does not deal at arm's length, to the corporation of which the taxpayer is a specified shareholder or to the partnership of which the taxpayer's share of any income or loss is 10% or more, as the case may be.

(3.2) For the purposes of subsection (3.1), costs relating to the construction, renovation or alteration of a building or to the ownership of land include

(*a*) interest paid or payable by a taxpayer in respect of borrowed money that cannot be identified with a particular building or particular land, but that can reasonably be considered (having regard to all the circumstances) as interest on borrowed money used by the taxpayer in respect of the construction, renovation or alteration of a building or the ownership of land; and

(*b*) interest paid or payable by a taxpayer in respect of borrowed money that may reasonably be considered (having regard to all the circumstances) to have been used to assist, directly or indirectly,

(i) another person with whom the taxpayer does not deal at arm's length,

(ii) a corporation of which the taxpayer is a specified shareholder, or

(iii) a partnership of which the taxpayer's share of any income or loss is 10% or more,

to construct, renovate or alter a building or to purchase land, except where the assistance is in the form of a loan to that other person, corporation or partnership and a reasonable rate of interest on the loan is charged by the taxpayer.

The legislation in subsection 20(29), however, does permit the deduction of soft costs during the construction period to the extent of the taxpayer's income, if any, from the rental of the building for the year. This provision is as follows:

> 20(29) Where, because of subsection 18(3.1), a deduction would, but for this subsection, not be allowed to a taxpayer in respect of an outlay or expense in respect of a building, or part thereof, and the outlay or expense would, but for that subsection and without reference to this subsection, be deductible in computing the taxpayer's income for a taxation year, there may be deducted in respect of such outlays and expenses in computing the taxpayer's income for the year an amount equal to the lesser of
>
> (*a*) the total of all such outlays or expenses, and
>
> (*b*) the taxpayer's income for the year from renting the building or the part thereof computed without reference to subsection (28) and this subsection.

Another wrinkle in the treatment of soft costs is discussed in Interpretation Bulletin *IT-121R3 Election to capitalize costs of borrowed money* (May 6, 1988). An exception exists for owners of property where the building is being constructed by an arm's length third party. In this case, the land *owner* does not have to capitalize its soft costs (i.e., the costs incurred by the owner that would otherwise be considered to be soft costs); however, the *builder* must still capitalize its soft costs. Specifically, the IT-bulletin states, at paragraph 17,

> Subsection 18(3.1) applies to certain outlays or expenses (referred to as "soft-costs") which include interest and other costs of borrowing money attributable to the period of the construction, renovation or alteration of a building. A current deduction for these outlays or expenses is denied if they relate to the construction, renovation or alteration of the building or relate to associated land owned during the period of such activity. However, for 1987 and subsequent taxation years, such a deduction will not be denied to a taxpayer who owns land and incurs soft-costs that relate to the land if they are attributable to a period when an arm's length person constructs, renovates or alters a building on that land on that person's own behalf. Any soft-costs incurred during this period by that arm's length person on his or her own behalf will continue to be subject to the restrictions in subsection 18(3.1).

The following is an example that illustrates the capitalization of construction soft costs.

Example application of construction soft costs.

Renters Limited is constructing a new apartment building. The land was purchased on February 15, 2000 for $405,000. There was no significant site preparation required so construction began immediately. The cost of the building was $1,348,000 plus the costs noted below. The building proved to be popular so all units were occupied when the building was completed on October 31, 2000. Rents for the final two months of the year amounted to $50,000.

In addition to the cost of the building were architect fees, $7,200, and engineering fees, $2,100.

To finance the project, Renters obtained a mortgage of $875,000 and issued $1,000,000 in preferred shares on January 15, 2000. Interest on the mortgage is payable semi-annually on July 15 and January 15 at a rate of 8% per annum. The preferred shares pay dividends of 5% per annum, payable semi-annually on July

15 and January 15. There were a number of costs incurred in order to issue the debt and shares. These costs are legal and accounting, $18,450, and commissions, $58,300.

The balance of the costs are	
Building insurance from April 15, 2000 ($450/mon)	$ 3,825
Property taxes from February 15, 2000 ($770/mon)	8,085
Soil testing to determine location of footings	1,825
Utility service connections, completed May 20, 2000	3,800
Mortgage insurance premium from March 1, 2000 ($325/mon)	3,250
Maintenance from October 31, 2000	2,500
Utilities from October 31, 2000	6,300
Landscaping	15,500

During the pre-construction period (January 15 to February 14), interest accruing on the mortgage is deductible under 20(1)(*c*)—the interest is not part of construction costs since construction had not yet begun.

Cost of building	$ 1,348,000
Soft costs capitalized to the building under 18(3.1):	
Architectural fees	7,200
Engineering fees	2,100
Building insurance during construction (6.5 mos x $450)	2,925
Property taxes during construction (8.5 mos x $770)	6,545
Soil testing	1,825
Utility service connection	3,800
Mortgage insurance during construction (8 mos x $325)	2,600
Interest accrued on mortgage (260/366 days x 8% x $875,000)	49,727
Less: rents received (as per 20(29))	(50,000)
Net soft costs	26,722
Total cost	$ 1,374,722

Other than the above amounts, expenses are deductible in computing income for 2000 as normal. For example, building insurance, property tax, insurance, maintenance and utilities, and interest applicable to the final two months of 2000 are all deductible. In addition, landscaping costs of $15,500 are deductible as an exception to the application of 18(3.1). Debt and share issue costs are deductible at 20% per year (as allowed under 20(1)(*e*)) because they are considered to be costs of long-term financing that are not attributable to the period of construction. Finally, CCA on building (see 3.2.2 below) of $27,494 is allowed (4% x $1,374,722 x 0.5).

2.2.6 Rules applicable to builder-renters: Completion and put-in-use rules

The date at which the building changes from being in the "construction period" to being "in use" is important because prior to this date the soft costs must be capitalized, but following the date, the soft costs can be expensed. Subsection 18(3.3) states

> 18(3.3) For the purposes of subsection (3.1), the construction, renovation or alteration of a building is completed at the earlier of the day on which the construction, renovation or alteration is actually completed and the day on which all or substantially all of the building is used for the purpose for which it was constructed, renovated or altered.

The common phrase "all or substantially all" is administered by CCRA to mean at least 90% as reflected in numerous IT-Bulletins which usually make the following statement: "when the level of 90% of whatever is being measured is reached, the 'all or substantially all' requirement is considered to have been met." (e.g., *IT-507R*, July 31, 1994). Thus, this provision would suggest that for a building being constructed as a residential rental building, the building is "in use" when it is at least 90% occupied by rental tenants, or it is finished, whichever occurs first.

A second distinct, but related concept, is the "available for use" rules (commonly called the "put-in-use" rules, though the Act does not use this phrase) found in subsections 13(26) and (27). These rules govern when the property owner is able to claim CCA on the building. In general, at the time of completion specified in 18(3.3), the building is also considered to be available for use, and CCA can be claimed. However, there is also the so-called "rolling start" rule in 13(29) that allows CCA to be claimed the second taxation year after the date the property was acquired by the taxpayer if it has not yet met the "completion" tests. Thus, capital costs and soft costs capitalized in 2000 are eligible for CCA in 2002 even if the 90% test is not met; similarly, additional costs incurred in 2001 are eligible for CCA in 2003; and so on until the completion rules are met. If CCA is claimed under these rolling start rules, the half-year rule is not applied. The relevant subsections in section 13 are as follows:

> 13(26) In applying the definition "undepreciated capital cost" in subsection (21) for the purpose of paragraph 20(1)(*a*) and any regulations made for the purpose of that paragraph, in computing a taxpayer's income for a taxation year from a business or property, no amount shall be included in calculating the undepreciated capital cost to the taxpayer of depreciable property of a prescribed class in respect of the capital cost to the taxpayer of a property of that class (other than property that is a certified production, as defined by regulations made for the purpose of paragraph 20(1)(*a*)) before the time the property is considered to have become available for use by the taxpayer.
>
> (28) For the purposes of subsection (26) and subject to subsection (29), property that is a building or part thereof of a taxpayer shall be considered to have become available for use by the taxpayer at the earliest of
>
> (*a*) the time all or substantially all of the building is first used by the taxpayer for the purpose for which it was acquired,
>
> (*b*) the time the construction of the building is complete,

(*c*) the time that is immediately after the beginning of the taxpayer's first taxation year that begins more than 357 days after the end of the taxpayer's taxation year in which the property was acquired by the taxpayer,

(*d*) the time that is immediately before the disposition of the property by the taxpayer, and

(*e*) where the property is (within the meaning assigned by subsection (4.1)) a replacement for a former property described in paragraph (4)(*a*) that was acquired before 1990 or that became available for use at or before the time the replacement property is acquired, the time the replacement property is acquired,

and, for the purpose of this subsection, a renovation, alteration or addition to a particular building shall be considered to be a building separate from the particular building.

(29) For the purposes of subsection (26), where a taxpayer acquires property (other than a building that is used or is to be used by the taxpayer principally for the purpose of gaining or producing gross revenue that is rent) in the taxpayer's first taxation year (in this subsection referred to as the "particular year") that begins more than 357 days after the end of the taxpayer's taxation year in which the taxpayer first acquired property after 1989, that is part of a project of the taxpayer, or in a taxation year subsequent to the particular year, and at the end of any taxation year (in this subsection referred to as the "inclusion year") of the taxpayer

(*a*) the property can reasonably be considered to be part of the project, and

(*b*) the property has not otherwise become available for use,

if the taxpayer so elects in prescribed form filed with the taxpayer's return of income under this Part for the particular year, that particular portion of the property the capital cost of which does not exceed the amount, if any, by which

(*c*) the total of all amounts each of which is the capital cost to the taxpayer of a depreciable property (other than a building that is used or is to be used by the taxpayer principally for the purpose of gaining or producing gross revenue that is rent) that is part of the project, that was acquired by the taxpayer after 1989 and before the end of the taxpayer's last taxation year that ends more than 357 days before the beginning of the inclusion year and that has not become available for use at or before the end of the inclusion year (except where the property has first become available for use before the end of the inclusion year because of this subsection or paragraph (27)(*b*) or (28)(*c*))

exceeds

(*d*) the total of all amounts each of which is the capital cost to the taxpayer of a depreciable property, other than the particular portion of the property, that is part of the project to the extent that the property is considered, because of this subsection, to have become available for use before the end of the inclusion year

shall be considered to have become available for use immediately before the end of the inclusion year.

2.3 Goods and Services Tax/Harmonized Sales Tax

The federal government, in addition to collecting income taxes, also collects a value-added tax called the Goods and Services Tax (GST), as reflected in the *Excise Tax Act* (ETA). On April 1, 1997, Nova Scotia, New Brunswick and Newfoundland, jointly with the federal government, became "participating provinces" under the *Excise Tax Act*, and so collect a Harmonized Sales Tax (HST) rather than the GST. The HST applies at a combined rate of 15% and includes a federal component (the national GST rate of 7%) and a provincial component (8%). Effective July 1, 1992, Quebec "harmonized" its sales tax with the GST. A system of input tax refunds was introduced for businesses for QST paid on inputs to their commercial activity, and the QST was extended to a broader range of goods and services paralleling GST. The QST is applied at 7.5% and there continue to remain small differences in the applicability and administration of the QST, relative to the GST. However, for the purposes of builders and providers of residential property, there do not seem to be major differences between the two systems.

In general, the GST/HST is a tax on the consumption of goods and services in Canada. The tax is collected by businesses (referred to as "registrants") who sell goods and provide services (collectively referred to as "supplies") in Canada. Any person who is engaged in a "commercial activity" is required to register and collect GST/HST. Since GST/HST is intended to be on final consumption, businesses are entitled to a credit for this tax paid on inputs. In general, goods and services are divided into three categories: "taxable supplies" which are subject to GST/HST at 7%/15% and the supplier receives a full input tax credit, "zero-rated supplies" which are subject to GST/HST at 0% and the supplier receives a full input tax credit, and "exempt supplies" which are not subject to GST/HST and the supplier does not receive an input tax credit.

The definitions of supplies is very broad and includes the sale or rental of goods; rendering of services; leases, sales and transfers of real property; and others. Among the exempt supplies are most financial services, sales of used residential housing, and rental of residential premises. Where a single business provides both taxable and exempt supplies, it is required to apportion the input tax credit between these two types of supplies (where only input tax credits for taxable supplies are allowed).

The provision of rental units is an exempt supply, and the provider is not entitled to input tax credits on costs incurred to provide the residential property. ETA: Schedule V — Exempt Supplies, Part I — Real Property, states in sections 6 through 7

6. A supply

(*a*) of a residential complex or a residential unit in a residential complex by way of lease, licence or similar arrangement for the purpose of its occupancy as a place of residence or lodging by an individual, where the period throughout which continuous occupancy of the complex or unit is given to the same individual under the arrangement is at least one month; or

(*b*) of a residential unit by way of lease, licence or similar arrangement for the purpose of its occupancy as a place of residence or lodging by an individual, where the consideration for the supply does not exceed $20 for each day of occupancy.

6.1. A supply of property that is

(*a*) land,

(*b*) a building, or that part of a building, that forms part of a residential complex or that consists solely of residential units, or

(*c*) a residential complex,

made by way of lease, licence or similar arrangement for a lease interval (within the meaning assigned by subsection 136.1(1) of the Act) throughout which the lessee or any sub-lessee makes, or holds the property for the purpose of making, one or more supplies of the property or parts of the property and all or substantially all of those supplies

(*d*) are exempt supplies described by section 6 or 7, or

(*e*) are supplies that are made, or are reasonably expected to be made, to other lessees or sub-lessees described in this section.

6.2. A supply of meals made by a person who is making a supply, described by paragraph 6(*a*), of a residential complex or unit where the meals are provided, to the occupant of the complex or unit, in the complex or unit or in the residential complex in which the unit is located under an arrangement whereby at least 10 meals per week are supplied for a single consideration determined before any meal is provided under the arrangement.

7. A supply

(*a*) of land (other than a site in a residential trailer park) made, under a lease, licence or similar arrangement which provides for continuous possession or use of the land for a period of at least one month, to

(i) the owner, lessee or person in occupation or possession of a residential unit that is or is to be affixed to the land for the purpose of its use and enjoyment as a place of residence for individuals, or

(ii) a person who is acquiring possession of the land for the purpose of constructing a residential complex on it in the course of a commercial activity,

(*b*) of a site in a residential trailer park made, under a lease, licence or similar arrangement which provides for continuous possession or use of the site for a period of at least one month, to the owner, lessee or person in occupation or possession of

(i) a mobile home, or

(ii) a travel trailer, motor home or similar vehicle or trailer,

situated or to be situated on the site, or

(*c*) of a lease, licence or similar arrangement referred to in paragraph (*a*) or (*b*) by way of assignment,

but not including any land on which the residential unit, mobile home, vehicle or trailer is or is to be affixed or situated, or any land contiguous to it, that is not reasonably necessary for the use and enjoyment of the unit, home, vehicle or trailer as a place of residence for individuals.

These inclusions in the list of exempt supplies, in turn, require the definitions of a "residential complex" and a "residential unit," which, in ETA: section 123, are as follows

"residential complex" means

(*a*) that part of a building in which one or more residential units are located, together with

(i) that part of any common areas and other appurtenances to the building and the land immediately contiguous to the building that is reasonably necessary for the use and enjoyment of the building as a place of residence for individuals, and

(ii) that proportion of the land subjacent to the building that that part of the building is of the whole building,

(*b*) that part of a building that is

(i) the whole or part of a semi-detached house, rowhouse unit, residential condominium unit or other similar premises that is, or is intended to be, a separate parcel or other division of real property owned, or intended to be owned, apart from any other unit in the building, and

(ii) a residential unit,

together with that proportion of any common areas and other appurtenances to the building and the land subjacent or immediately contiguous to the building that is attributable to the unit and that is reasonably necessary for its use and enjoyment as a place of residence for individuals,

(*c*) the whole of a building described in paragraph (*a*), or the whole of a premises described in subparagraph (*b*)(i), that is owned by or has been supplied by way of sale to an individual and that is used primarily as a place of residence of the individual, an individual related to the individual or a former spouse of the individual, together with

(i) in the case of a building described in paragraph (*a*), any appurtenances to the building, the land subjacent to the building and that part of the land immediately contiguous to the building, that are reasonably necessary for the use and enjoyment of the building, and

(ii) in the case of a premises described in subparagraph (*b*)(i), that part of any common areas and other appurtenances to the building and the land subjacent or immediately contiguous to the building that is attributable to

the unit and that is reasonably necessary for the use and enjoyment of the unit,

(*d*) a mobile home, together with any appurtenances to the home and, where the home is affixed to land (other than a site in a residential trailer park) for the purpose of its use and enjoyment as a place of residence for individuals, the land subjacent or immediately contiguous to the home that is attributable to the home and is reasonably necessary for that purpose, and

(*e*) a floating home,

but does not include a building, or that part of a building, that is a hotel, a motel, an inn, a boarding house, a lodging house or other similar premises, or the land and appurtenances attributable to the building or part, where the building is not described in paragraph (*c*) and all or substantially all of the leases, licences or similar arrangements, under which residential units in the building or part are supplied, provide, or are expected to provide, for periods of continuous possession or use of less than sixty days;

"residential condominium unit" means a residential complex that is, or is intended to be, a bounded space in a building designated or described as a separate unit on a registered condominium or strata lot plan or description, or a similar plan or description registered under the laws of a province, and includes any interest in land pertaining to ownership of the unit;

2.3.1 Rules applicable to builder-sellers

As a builder-seller, an enterprise would fall under the general rules for GST/HST. Sales of new single-family homes would require GST/HST to be collected and the builder is able to claim an input tax credit for GST/HST paid during the acquisition and construction processes. For example, when a builder incurs GST in respect of legal and accounting fees during construction of the house, or in respect of the related land, the tax may be recovered as an input tax credit. Certain other soft costs incurred by builders are classified as exempt supplies under the ETA, and hence, not subject to GST/HST. These would include, for example, interest, insurance, and property taxes.

On October 4, 2000, proposed amendments to the GST system for residential properties was tabled. If passed, a New Housing Rebate will be available on qualified purchases after February 27, 2000. The rebate is equal to 2.5% of the cost (36% of the GST paid) for newly-constructed residential accommodation for use as a primary place of residence.

Normally, sales of used residential properties are exempt from GST. However, special rules apply to "substantial renovations" of used residential properties. These rules are intended to ensure that persons in the business of renovating homes for resale are treated in a manner similar to builders of new homes. The term "substantial renovation" is defined in ETA: subsection 123(1) as follows

> "substantial renovation" of a residential complex means the renovation or alteration of a building to such an extent that all or substantially all of the building that existed immediately before the renovation or alteration was begun, other than the foundation, external walls, interior supporting walls, floors, roof and staircases, has been removed or replaced where, after completion of the renovation or alteration, the building is, or forms part of, a residential complex.

Since the sale of a substantially renovated home is treated the same as a sale of a new home, GST/HST is charged on the sale and the builder is able to claim an input tax credit on any purchases of property and services. If the renovation is not considered to be a substantial renovation, the renovator is still required to pay GST/HST on purchases of property and services; however no GST/HST is charged on the property's sale and no input tax credit is permitted.

2.3.2 Rules applicable to builder-renters

Where the registrant is a builder-renter, the land and building acquired and constructed will be treated as capital real property, just as described above for income tax purposes. Special rules apply to the input tax credits for such property. Capital real property is defined in the ETA to include any property that is capital property for income tax purposes, other than property included in class 12 or class 14 of the capital cost allowance classes defined in the *Income Tax Regulations*. This definition for GST/HST purposes applies regardless of whether the registrant is a taxpayer under the *Income Tax Act*.

The term real property is defined in subsection 123(1) of the ETA as follows:

> "real property" includes
> (*a*) in respect of property in the Province of Quebec, immovable property and every lease thereof,
> (*b*) in respect of property in any other place in Canada, messuages, lands and tenements of every nature and description and every estate or interest in real property, whether legal or equitable, and
> (*c*) a mobile home, a floating home and any leasehold or proprietary interest therein;

An important feature of the GST/HST system is that the long-term rental of capital real property to individuals is an exempt supply. Separate sets of rules relating to input tax credits for capital real property are applicable, depending on whether the registrant is an individual (i.e., a sole proprietor), or any other type of business. The rules for individuals are designed to account for any personal use of capital property and other exempt uses;

however, to the extent that the builder-renter only rents the property out as residential property, the two sets of rules do not result in any substantive differences in application.

Specifically, if an individual uses the capital real property for either personal use or exempt supply (for example, residential rental), then no input tax credits are permitted on the acquisition or improvement costs. An input tax credit is only permitted to an individual if the provision of non-exempt supplies account for more than 50% of the property. If the registrant is not an individual, the threshold is only 10% of the property must be used in the provision of non-exempt supplies. Once these thresholds have been passed, the registrant is entitled to a portion of the input tax credit. The portion is equal to the ratio of amount of the property devoted to the provision of non-exempt supplies to the total amount of the property. Common methods of computing this ratio are either floor space or rental revenues.

Example application of input tax credits to residential apartment building.

Suppose the ground floor of an apartment building is leased to business occupants with total lease revenue of $200,000, while other floors are leased to residential tenants with a total lease revenue of $800,000.

In this case, if the building owner is not an individual, it is entitled to an input tax credit of 20% of all GST/HST paid on taxable supplies that apply to the building as a whole, including all construction costs.

If the building is owned by an individual, the commercial use does not exceed 50% and no input tax credit is permitted.

When the property is sold, the sale is exempt and no GST/HST need be collected if the property is used as a residential property exclusively (or primarily if it is an individual). However, where the vendor previously claimed an input tax credit as a result of commercial uses of the building, the sale would be taxable as follows. Where the property was used partially in commercial activities prior to the sale, the registrant must account for GST/HST based on an allocation of the value into two separate supplies: an exempt residential supply and a taxable commercial supply.

2.4 Provincial Corporate Income Taxes

The provinces and territories in Canada fall into three basic categories for corporate income tax purposes. British Columbia, Saskatchewan, Manitoba, Prince Edward Island, Nova Scotia, New Brunswick, Newfoundland and Labrador, and all of the territories operate under collection agreements with the federal government. These agreements basically provide for the province to use the federal computation of taxable income, but apply a

provincial rate determined by provincial statute. Thus, any corporate income tax provisions that exist in the federal *Income Tax Act*, apply equally in these provinces.

A second category of provinces consists of Alberta and Ontario. These two provinces are not part of the collection agreements with the federal government, and as a result the provincial calculation of taxable income may deviate from the computation for federal purposes. However, to date, these provincial governments have not enacted any income tax provisions that affect the producers of residential property or the providers of rental housing differently from those found in the federal statutes.

A third category of provinces is Quebec. Quebec is also not part of the collection agreements with the federal government. However, unlike Alberta and Ontario, Quebec maintains a significantly different system of income taxation that provides many different provisions.

2.4.1 Rates and rules

Changes to corporate tax rates are applied proportionately based on the number of months in the taxation year prior to, versus those following, a rate or legislative change. The provincial rates applicable to corporations' taxable income are summarized in the table on the following page [source: CCH Canadian Limited, *Canadian Income Tax Act with Regulations, 71st Edition* (2000)]. Rates presented are based on a taxation year ended on December 31, 2001.

One major issue within provincial corporate income taxes arises when a corporation has a permanent establishment in more than one province. A permanent establishment is defined in the Act's Regulation 400(2) as a fixed place of business of the corporation, including an office, a branch, a mine or oil well, a farm, a timber land, a factory, a workshop or a warehouse. The corporation is deemed to have a permanent establishment by Regulation 400(2)(*b*) if the corporation carries on business through an employee or agent, established in a particular place, who has general authority to contract for his or her employer or principal, or who has a stock of merchandise owned by his or her employer or principal from which he or she regularly fills orders which he or she receives. Having a commissioned agent or broker, or maintains an office solely for the purchase of merchandise, does not of itself mean that the corporation has a permanent establishment (Regulation 400(2)(*f*)). However, the use of substantial machinery in a province (Regulation 400(2)(*e*)), or ownership of land in a province (Regulation 400(2)(*d*)), will constitute a permanent establishment in that province.

Table 1: Provincial Corporate Income Tax Rates, 2001				
	General (Non-Manufacturing)		Small Business[1]	
Federal rate		28.12		13.12
	Provincial	Combined	Provincial	Combined
British Columbia	16.5	44.62	4.5	17.62
Alberta	13.5[2]	41.62	5[2]	18.12
Saskatchewan	17	45.12	8	21.12
Manitoba	17	45.12	6[3]	19.12
Ontario	14	42.12	6.5[4]	19.62
Quebec (active)[5]	9.04	37.16	9.04	22.16
New Brunswick	17	45.12	4.5	17.62
Nova Scotia	16	44.12	5	18.12
Prince Edward Island	16	44.12	7.5	20.62
Newfoundland	14	42.12	5	18.12
Yukon	15	43.12	6	19.12
Northwest Territories	14	42.12	5	18.12
Nunavut	14	42.12	5	18.12

[1] These rates apply to income up to $200,000. The federal government also announced a reduced rate of 21% (plus the surtax) for income between $200,000 and $300,000. The federal small business deduction clawback also applies for purposes of the provincial small business deduction in territories and all of the provinces except Ontario.

[2] Alberta has announced reductions in its tax rates. Annual reductions will ultimately bring the general rate to 8% in 2004 and the small business rate to 3% in 2003. The small business threshold is $300,000 for 2001 and $400,000 for 2002.

[3] Manitoba's small business tax rate decreased from 7% to 6% on January 1, 2001 and will decrease by an additional 1% on January 1, 2002, when the rate will be 5%.

[4] Ontario's small business tax rate decreased from 7% to 6.5% on January 1, 2001, and additional reductions will be phased in so that the rate will decline to 4% on January 1, 2005. The reduced rate applies to income up to $240,000 in 2001. Ontario imposes a surtax to claw back their small business deduction, on a graduate basis, when taxable income of associated corporations exceed $240,000 for 2001. Once taxable income, on an associated basis, reaches $600,000, the deduction is eliminated completely. Increases to the $240,000 and $600,000 thresholds will be phased in so that the thresholds will be $400,000 and $1,000,000, respectively, on January 1, 2005.

[5] Quebec rates reflect a 1.6% Youth Fund surtax that applies from March 15, 2000 to March 14, 2003, inclusive.

Once it is determined that a corporation has a permanent establishment in a province or territory, a portion of the company's taxable income is attributed to that jurisdiction. To determine the attribution, a formula in Regulation 402 must be used. The formula is based on the proportion of gross revenues earned through a permanent establishment in a province

or territory and the proportion of salaries and wages expense paid through the same permanent establishment in that jurisdiction, relative to the total gross revenues and salaries and wages expense, respectively, of the corporation. The aggregate proportion of income attributed to permanent establishments in Canada then determines the proportion of income eligible for the 10% provincial abatement from federal taxes.

Example application of apportionment formula for provincial income taxes.

DEF Limited, with its head offices in Ottawa, Ontario and other permanent establishments in the provinces of New Brunswick and Quebec, and in the United States, has taxable income of $325,000.

The corporation's gross revenue and salaries and wages are attributable to its permanent establishments as follows:

	Gross revenue	Salaries and wages
Ontario	$ 780,000	$530,000
New Brunswick	2,340,000	120,000
Quebec	2,600,000	185,000
U.S.	390,000	65,000
total	$6,110,000	$900,000

The allocation of taxable income to each province would be as follows:

	Gross revenue		Salaries and wages		Average	Taxable
	Amount	%	Amount	%	%	Income
Ontario	$ 780,000	12.8%	$530,000	58.9%	35.8%	$116,350
New Brunswick	2,340,000	38.3	120,000	13.3	25.8	83,850
Quebec	2,600,000	42.6	185,000	20.6	31.6	102,700
subtotal	$5,720,000	93.7%	$835,000	92.8%	93.2	$302,900
U.S.	390,000	6.3	65,000	7.2	6.8	22,100
total	$6,110,000	100.0%	$900,000	100.0%	100.0%	$325,000

In this example, 93.2% of income is attributable to a permanent establishment in Canada. For federal tax purposes, the corporation will receive 93.2% of the 10% provincial tax abatement, or an abatement of 10% of $302,900. Each of the three provinces will tax the amount of allocated taxable income determined in the final column of the table above.

The three provinces that are not part of the collection agreements have voluntarily agreed to comply with the federally-mandated provincial tax allocation as presented above. However, it is possible that one or more of these provinces will choose to apply a different allocation formula in the future.

2.5 Provincial Sales Taxes

British Columbia, Saskatchewan, Manitoba, Ontario, Prince Edward Island and the territories collect a provincial sales tax. The remaining provinces are either part of the HST system, or in the case of Quebec, collect a tax that closely parallels the GST, or in the case of Alberta and the territories, do not collect any form of sales tax. Rates and type of sales tax are presented in the following table:

Table 2: Provincial Sales Tax Rates, 2001

	Sales Tax Rate	Type of Tax
British Columbia	7.0	Retail sales tax
Alberta	–	No tax imposed
Saskatchewan	6.0	Retail sales tax
Manitoba	7.0	Retail sales tax
Ontario	8.0	Retail sales tax
Quebec	7.5	Value-added tax, like GST
New Brunswick	8.0	Harmonized Sales Tax
Nova Scotia	8.0	Harmonized Sales Tax
Prince Edward Island	10.0	Retail sales tax
Newfoundland	8.0	Harmonized Sales Tax

Basic details of the taxes are outlined below.

2.5.1 Basic rules of retail sales taxes

The sales tax applied by the five provinces have subtle differences, but generally operate in the same manner. The taxes are applied on the sale or lease of tangible personal property that is intended for consumption or use by individuals; tangible personal property is defined slightly differently for each province. In addition to tangible personal property, various other goods and services may, or may not, be taxed by the sales tax system in a particular province. For example, electricity and telecommunications are included in all provinces, but computer software is included in British Columbia, whereas all computer services are included in Saskatchewan.

Since the tax is intended to apply to the ultimate consumer, many classes of goods that are used in the manufacturing, or intended for resale or lease by the purchaser, are exempt under the systems. The mechanisms to ensure registered vendors pay little or no sales taxes

vary by province. In some provinces, like B.C. and Ontario, registered vendors are exempt from the tax (avoid paying it by presenting their registration number).

2.5.2 Retail sales tax and real property

Real property and property that becomes real property upon installation are not part of tangible personal property; therefore, the sale of real property is exempt from the sales tax. In these cases, property purchased by the company or individual undertaking the construction is considered to be tangible personal property and the sales tax is paid at this level. The ultimate owner of the real property does not pay sales tax directly, nor is the value added (e.g., labour) involved in construction or installation taxable. Where the contractor also manufactures components that become part of the real property, the contractor must pay the retail sales tax, through self assessment, on the value of the manufactured components.

Residential rent is also excluded from sales tax because the residential property is not taxable personal property.

2.6 Land Transfer Taxes

British Columbia, Manitoba, and Ontario also collect a tax on the sale of real estate: a land transfer tax. The remaining provinces and the territories do not collect this type of tax.

2.6.1 British Columbia

The rate of tax payable is 1% of the first $200,000 of the fair market value of the taxable transaction and 2% of the remaining fair market value of the taxable transaction. The base for the tax is the fair market value of the property being transferred. In most cases, this is the transaction amount since there is a presumption that a sale between a willing buyer and a willing seller who deal with one another at arm's length is at fair market value.

A full exemption from the land transfer tax may be claimed when all the buildings (improvements) situated on the land are classified as residential and the land does not exceed 0.5 hectares in size. A partial exemption for principal residence is available when some of the buildings on the property are residential. In this instance, only that portion of property classified as residential can be exempt from tax and the fair market value of residential buildings is exempt. When the land exceeds 0.5 hectares in size, the exemption

applies only to the first 0.5 hectares of land and the exemption is calculated by multiplying the fair market value of the land by ratio of 0.5 hectares divided by the total area of the parcel.

2.6.2 Manitoba

The land transfer tax in Manitoba is imposed on every person who transfers land. The tax is calculated according to a formula based on the fair market value of the property at the time the transfer is tendered for registration. (Section 34, *The Revenue Act of Manitoba*).

2.6.3 Ontario

The tax rate is 0.5% of the first $55,000, 1.0% of the next $195,000 and 1.5% of the balance. In Ontario, there is a taxable transfer if (i) there will be a registration; (ii) the document to be registered is a conveyance; and (iii) the conveyance conveys land. For this tax, "land" includes

> lands, tenements and hereditaments and any estate, right or interest therein, a structure to be constructed on land as part of an arrangement relating to a conveyance of land, a leasehold interest or estate, the interest of an optionee, the interest of a purchaser under an agreement to sell land, or goodwill attributable to the location of land or to the existence thereon of any building or fixture, and fixtures.

Thus, the value for the tax is the value of the land plus anything on the land (e.g., buildings). The tax applies equally to residential and non-residential property.

2.7 Provincial Capital Taxes

In addition to the federal capital tax, that effectively represents an alternative minimum tax, most provinces impose a general capital tax on corporations, other than financial institutions, that have a permanent establishment there (all provinces impose a capital tax on financial institutions).

Below is a chart of 2001 capital tax rates [source: CCH Canadian Limited, *TaxWorks CD* (October 2000)]. The calculation of the tax base or taxable capital may differ from province to province but generally is similar to that for the federal LCT, described in section 2.2.1. Exemptions and reduced rates apply in certain cases. Computations for financial institutions follow special rules not applicable to other corporations.

Table 3: Corporate Capital Tax Rates, 2001		
	Rate	**Notes**
Federal	0.225%	The federal tax is the Large Corporations Tax, discussed in section 2.2.1.
British Columbia	0.3%	
Alberta	none	
Saskatchewan	0.6%	Saskatchewan imposes a capital tax surcharge on large resource corporations.
Manitoba	0.3% or 0.5%	0.2% surcharge on corporations with taxable capital over $10 million
Ontario	0.3%	
Québec	0.64%	
New Brunswick	0.3%	
Nova Scotia	0.25%	
Prince Edward Island	none	
Newfoundland	none	
All territories	none	

3 Taxation on Providers of Rental Housing

3.1 Overview

The provision of rental housing in Canada is provided by corporations, individuals and hybrid organizations like Real Estate Investment Trusts (REITs). Some rules, such as the basic calculation of CCA, are applicable to each of these types of organizations in the same manner. However, in certain cases, there are special rules that apply to a particular type of organizational form. These special rules will be described under the form of organization following a presentation of the rules generally applicable.

Sections 2.2.1 and 2.2.2 describe the basic rules for the federal income taxation of corporations engaged in the rental of residential property, section 2.3.2 describes the rules of GST applicable to providers of residential rental properties, section 2.4.1 describes provincial corporate income tax rates, and 2.5.2 describes applicable sales tax rules and rates. The following sections provide elaboration on these taxes, but only as they apply specifically to the provision of rental accommodation and are not discussed in the previous sections. In addition, general rules relating to the personal income tax system in Canada are also included here because individuals own rental buildings—both houses and multi-unit complexes—but generally do not build them.

Municipalities and cities also have limited ability to levy taxes. Provinces authorize municipalities to collect certain types of taxes to raise revenues for locally-provided services. The major form of these local taxes are property taxes. A variety of other levies are sometimes also collected. To provide a cross-section of the local tax environment, six major urban areas, Vancouver, Calgary, Winnipeg, Toronto, Montreal and Halifax, have been chosen to demonstrate the forms and rates applicable at the local government level.

3.2 CCA System for Rental Units

3.2.1 CCA system in general

The capital cost allowance (CCA) system is the legislated system to deduct the capital cost of depreciable property against business and property income. The deduction of CCA is allowed by paragraph 20(1)(*a*), but the rates and many of the rules are set out in the

Regulations. The major class for rental properties is "buildings" which are included in Class 3 if purchased prior to 1988, and class 1 if purchased after 1987. CCA can be claimed on class 3 assets at a rate of 5%, whereas class 1 assets have a rate of 4%. Rules specifically applicable to rental properties are described at the end of this section, and in 3.2.2 and 3.2.3, below.

In general, the CCA system works as follows. In the year of acquisition, CCA is limited to half of the cost of net additions (additions less dispositions as described below; this rule is generally called the "half-year rule"). In the year of disposition, the lesser of the proceeds of disposition and original capital cost are deducted from the undepreciated capital cost (UCC) in the class. If the balance is negative, this suggests that too much CCA had been claimed in the past. Therefore, the amount of the negative balance is included in income in the year; this inclusion is called recapture and when added to the negative UCC balance of the class restores the UCC balance to zero.

If adding the lesser of the proceeds of disposition and original capital cost for the disposition does not result in a negative balance, and there continue to be other assets in the class, the CCA for the year is simply the rate times the new UCC balance. If there are no longer any assets in the particular class and the UCC balance is positive, then insufficient CCA had been claimed in the past. In this case, a deduction is permitted equal to the UCC balance, called a terminal loss. When the corporation has a short year, the CCA claim must be prorated for the number of days in the taxation year.

Example application of CCA rules:

PQR Limited began operations on January 1, 1998 and has a December 31 year end. Among other assets, it purchased office furniture for its rental office with a total cost of $5,000. In 1999, it purchased additional furniture for $2,000 and disposed of two desks for $500 (capital cost of $750). In 2001, it disposed of its remaining office furniture for (a) $1,000, or (b) $4,500.

CCA calculations are as follows:

	1998	1999	2000	2001.a	2001.b
UCC balance, January 1	$ 0	$ 4,500	$ 4,950	$ 3,960	$3,960
Add: additions	5,000	2,000	–	–	–
Less: dispositions	–	(500)	–	(1,000)	(4,500)
UCC before adjustments	5,000	6,000	4,950	2,960	(540)
Less: half of net additions	(2,500)	(750)	–	–	–
UCC before CCA	2,500	5,250	4,950	2,960	(540)
CCA at 20%	(500)	(1,050)	(990)		
Terminal loss				(2,960)	
Recapture					540
Add: half of net additions	2,500	750	–	–	–
UCC balance, December 31	$ 4,500	$ 4,950	$ 3,960	Nil	Nil

> In this example, when the remaining assets in the class are sold for less than the UCC balance in the class (case a), an additional deduction (the terminal loss) is permitted because the CCA did not fully reflect the decline in asset values. In the second case where the assets were sold for greater than the UCC balance (case b), the CCA claims had been too great, and an income inclusion (the recapture) is created.
>
> The subtraction and subsequent addition of "half of net additions" is how the half-year rule is implemented.
>
> If, for example, PQR Limited had begun business on February 1, 1998 and maintained a December 31 year end, the first year's CCA would have to be prorated for the short year. Thus, 1998 CCA would be $458 (calculated as 334 days/365 days x 500).

If there is more than one asset in a CCA class, the sale of a property in the class does not give rise to recapture (though may result in a capital gain if sold for more than its capital cost). Thus, a deferral can occur because even though some assets in the class are sold, the remaining UCC of the class may still be positive.

Deferring recapture on the sale of a rental building by owning other rental buildings, however, was not seen as desirable. Therefore, the regulations require that each rental building owned by any taxpayer with a capital cost of $50,000 or more be placed in a separate class (Regulation 1101(*ac*)). By using separate classes for each building, recapture is included in (or terminal losses deducted from) income upon each property's sale. The $50,000 amount has not been changed since its introduction in 1972, causing virtually all rental buildings purchased now to be placed in their own CCA class, rather than just larger ones as was originally the case.

3.2.2 Principal Business Corporation (PBC) definition and application

Where a corporation provides rental housing, there are exceptions made in the Act and its regulations for corporations that are referred to as Principal Business Corporations (or PBCs). The Act does not use this term directly, but instead uses the phrase (as found, for example, in 18(2)(*f*), previously discussed, or Regulation 1100(12), discussed below)

> a corporation whose principal business was the leasing, rental, development or sale, or any combination thereof, of real property owned by it

CCRA's interpretation of what constitutes a PBC in these contexts is set out in *IT-371 Rental property — Meaning of "principal business"* (April 25, 1977). An initial consideration is that the corporation must be in the *business* of leasing real property. Therefore, the

distinction between providing rental units as an active business versus a passive property investment is important as a starting point. If the corporation simply provides the units with very little additional services, this may be found not to constitute a business, but to be a passive investment in property—which gives rise to property income, not business income.

The IT-Bulletin mainly focuses on when a corporation engages in more than one business, what is its *principal* business. The bulletin states the following:

> 5. Whether or not a business is a "principal" business is a matter of significance only where the taxpayer carries on more than one business in the taxation year. The phrase "principal business" is not defined by the Act or the Regulations and accordingly the words must be given their usual meaning and the identity of a taxpayer's principal business determined from the facts of the particular case.
>
> 6. Regulation 1100(12) requires that the business be the taxpayer's principal business "throughout the year". In this respect it is similar to subsection 18(8) of the Act but it is unlike other references to "principal business" in the Act (for example, subsection 66(2) and subparagraph 133(8)(*d*)(iv)) which only require the particular business to have been a principal business in the taxation year. Nevertheless it is the Department's view that the criteria for identifying a principal business for the purposes of Regulation 1100(12) are not different from those set out in Interpretation Bulletin IT-290, "Non-Resident-Owned Investment Corporation — Meaning of Principal Business".
>
> 7. There is no standard set of criteria that may be looked to where the nature of each of a taxpayer's businesses is known but it must be determined which of them is his principal business; the significant factors of each case must be searched out and evaluated. In the Department's view the following are among the factors which may be relevant:
>
> (*a*) the profits realized by each of the businesses;
>
> (*b*) the volume and the value of the gross sales or transactions of each business;
>
> (*c*) the value of the assets of each business;
>
> (*d*) the capital employed in each business; and
>
> (*e*) the time, attention and effort expended by the employees, agents or officers in each business.

When a corporation qualifies as a PBC in the business of leasing of real property, the deductibility of property-related costs and CCA are the same rules as those applicable to most corporations carrying on a business. That is, the special requirements to capitalize property taxes and interest in some cases, described above, and the CCA limitations, described below, do not apply to PBCs, just as they do not apply to most corporations.

3.2.3 Implications of not being a PBC

If the taxpayer owning the land is a corporation that is not a PBC, or an individual, then the limitations on CCA claims found in Regulation subsections 1100(11) to 1100(17) apply. These regulations limit the CCA that may be claimed to the amount of income that is reported, before that claim of CCA is made. In other words, these taxpayers cannot create a loss by claiming CCA in the year.

The regulations state

> 1100(11) Notwithstanding subsection (1), in no case shall the aggregate of deductions, each of which is a deduction in respect of property of a prescribed class owned by a taxpayer that includes rental property owned by him, otherwise allowed to the taxpayer by virtue of subsection (1) in computing his income for a taxation year, exceed the amount, if any, by which
>
> (*a*) the aggregate of amounts each of which is
>
> (i) his income for the year from renting or leasing a rental property owned by him, computed without regard to paragraph 20(1)(*a*) of the Act, or
>
> (ii) the income of a partnership for the year from renting or leasing a rental property of the partnership, to the extent of the taxpayer's share of such income,
>
> exceeds
>
> (*b*) the aggregate of amounts each of which is
>
> (i) his loss for the year from renting or leasing a rental property owned by him, computed without regard to paragraph 20(1)(*a*) of the Act, or
>
> (ii) the loss of a partnership for the year from renting or leasing a rental property of the partnership, to the extent of the taxpayer's share of such loss.
>
> (12) Subject to subsection (13), subsection (11) does not apply in respect of a taxation year of a taxpayer that was, throughout the year,
>
> (*a*) a life insurance corporation, or a corporation whose principal business was the leasing, rental, development or sale, or any combination thereof, of real property owned by it; or
>
> (*b*) a partnership each member of which was a corporation described in paragraph (*a*).
>
> (13) For the purposes of subsection (11), where a taxpayer or partnership has a leasehold interest in a property that is property of Class 1, 3 or 6 in Schedule II by virtue of subsection 1102(5) and the property is leased by the taxpayer or the partnership to a person who owns the land, an interest therein or an option in respect thereof, on which the property is situated, this section shall be read without reference to subsection (12) with respect to that property.
>
> (14) In this section and section 1101, "rental property" of a taxpayer or a partnership means

(*a*) a building owned by the taxpayer or the partnership, whether owned jointly with another person or otherwise, or

(*b*) a leasehold interest in real property, if the leasehold interest is property of Class 1, 3, 6 or 13 in Schedule II and is owned by the taxpayer or the partnership,

if, in the taxation year in respect of which the expression is being applied, the property was used by the taxpayer or the partnership principally for the purpose of gaining or producing gross revenue that is rent, but, for greater certainty, does not include a property leased by the taxpayer or the partnership to a lessee, in the ordinary course of the taxpayer's or partnership's business of selling goods or rendering services, under an agreement by which the lessee undertakes to use the property to carry on the business of selling, or promoting the sale of, the taxpayer's or partnership's goods or services.

(14.1) For the purposes of subsection (14), gross revenue derived in a taxation year from

(*a*) the right of a person or partnership, other than the owner of a property, to use or occupy the property or a part thereof, and

(*b*) services offered to a person or partnership that are ancillary to the use or occupation by the person or partnership of the property or the part thereof

shall be considered to be rent derived in that year from the property.

(14.2) Subsection (14.1) does not apply in any particular taxation year to property owned by

(*a*) a corporation, where the property is used in a business carried on in the year by the corporation;

(*b*) an individual, where the property is used in a business carried on in the year by the individual in which he is personally active on a continuous basis throughout that portion of the year during which the business is ordinarily carried on; or

(*c*) a partnership, where the property is used in a business carried on in the year by the partnership if at least 2/3 of the income or loss, as the case may be, of the partnership for the year is included in the determination of the income of

(i) members of the partnership who are individuals that are personally active in the business of the partnership on a continuous basis throughout that portion of the year during which the business is ordinarily carried on, and

(ii) members of the partnership that are corporations.

Similar rules apply to the furniture and fixtures found in a rental unit (Regulations 1100(15) to (20)). These regulations are discussed in an Interpretation bulletin, *IT-195R4 Rental property — Capital cost allowance restrictions* (September 6, 1991). An example of how these rules, plus the $50,000 rule described at the end of 3.2.1, above, are applied is presented below.

Example application of CCA limitations.

Mrs. Z owns five rental buildings with the following information pertaining to each:

	Building				
	1	2	3	4	5
Cost	$ 30,000	$ 132,000	$ 71,000	$ 49,000	$ 350,000
UCC, January 1, 2000	22,000	90,000	49,000	40,000	238,000
Rental revenue in 2000	1,600	17,000	8,000	3,800	45,000
Cash expenses:					
Interest	Nil	1,200	1,700	Nil	3,200
Property taxes	400	3,000	1,500	800	8,000
Other expenses	800	11,000	7,500	1,600	29,000

Late in 2000, buildings 1 and 2 were sold for proceeds of $40,000 and $91,000, respectively. Building 5 was purchased in 1994; all other buildings were purchased prior to 1989.

The maximum CCA that can be claimed for tax purposes, assuming she owns no other rental properties and all buildings are of brick construction, is computed as follows

	Class 3: 5%			Class 1: 4%
	Under $50,000	Building 2	Building 3	Building 5
UCC, January 1, 2000	$ 62,000	$ 90,000	$ 49,000	$ 238,000
Dispositions during the year	30,000*	91,000	–	–
UCC, December 31, 2000	$ 32,000	($ 1,000)	$ 49,000	$ 238,000
CCA for 2,000 (max. $6,700 below)	Nil†	–	Nil†	6,700
Recapture	–	1,000	–	–
UCC, January 1, 2001	$ 32,000	Nil	$ 49,000	$ 231,300

Total rental revenue in 2000	$ 75,400
Add: recapture [subsections 13(1)–(3)]	1,000
Less: total cash expenses	(69,700)
Net before CCA	6,700
CCA	(6,700)
Loss on rental properties	Nil

* The balance is never reduced by more than the original cost on the disposition of an asset; a capital gain of $10,000 (i.e., $40,000 – $30,000) is also generated.

† CCA potentially available in 2000:

Buildings with cost under $50,000 (5% x 32,000)	$ 1,600
Building 3 (5% x 49,000)	2,450
Building 5 (4% x 238,000)	9,520
Total	$ 13,570

Where deducting the maximum allowable CCA is not permissible (as in this case or the case of a non-PBC) or not desirable, it is usually advisable to take CCA in lower-rate classes first. This preserves a higher balance in the higher-rate classes for the future when it may be possible to deduct relatively higher amounts of CCA in the higher-rate classes.

3.2.4 Non-profit corporations

Corporations that operate as not-for-profit entities to provide rental housing, such as residential co-operatives, do not operate with a profit motive. These corporations also do not pay income taxes and so the claiming of CCA, and related restrictions, are not relevant. While the filing of an information return is required, there are no special income tax rules relating to these entities.

3.3 Federal Personal Income Taxes

3.3.1 Overview of the rates and structure across Canada

Individuals resident in Canada are liable for tax on their income. The rules for computing income for an individual under Division B or Part I of the Act are identical in most cases to those for computing income for a corporation. The general rules of computing income for individuals are included in the discussion in 2.2.1, above.

Beginning in 2001 (as announced in the February 2000 Budget and October 2000 Economic Statement and Budget Update), the federal personal income tax system has four rate categories. The rate of tax for individuals during 2001 is as follows:

Taxable income	*Tax*
$30,754 or less	16%
$30,755 to $61,509	$4,921 + 22% on excess over $30,754
$61,510 to $100,000	$11,687 + 26% on excess over $61,509
in excess of $100,000	$21,695 + 29% on excess over $100,000

In Quebec, the rates are reduced by a factor of 83.5% due to a federal abatement of 16.5%. Thus, the rates in the four income brackets are approximately 13.36%, 18.37%, 21.71% and 24.22%, respectively, for individuals in Quebec.

From the federal tax computed in this manner, various tax credits are permitted, typically at a rate of 16%. Some of these credits are not refundable, and so are only deducted to the extent that federal tax is reduced to zero. While the excess or unused credits are not refunded to the taxpayer, many may be transferred to a supporting individual or carried forward to be claimed in a future year. Other credits are refunded to the taxpayer to the extent that they are greater than federal taxes otherwise payable. The method of arriving at federal income tax payable for a particular year is as follows:

Computation of income under Division B	$ xxxx
Less: Division C deductions (e.g., RRSP, loss carry-overs)	xx
Taxable income	$ xxxx
Federal income tax on taxable income	$ xxx
Subtract: non-refundable credits	xxx
Federal tax after non-refundable credits (must not be less than zero)	xxx
Subtract: refundable credits	xxx
Net federal tax	$ xxx

While there are many tax credits that are permitted for individuals in the *Income Tax Act*, none pertain specifically to those providing residential rental property, or to those owning or renting residential property.

3.3.2 Loss utilization and the reasonable expectation of profit test

In addition to the rules that limit the deductibility of CCA for individuals, there is an additional limitation that has been imposed in common law. This has come to be known as the "reasonable expectation of profit" (REOP) test. CCRA, citing several key court cases backing the practice, has denied for tax purposes any rental losses (including terminal losses realized on the sale of the property) under the basis that their investment did not have a reasonable expectation of profit.

The test first arose in the 1977 case of *Moldowan v. The Queen* [SCC] 77 DTC 5213 where the Supreme Court of Canada was asked to determine if the farming losses of the taxpayer could be deducted. In his decision, Mr. Justice Dickson states at 5215,

> Although originally disputed, it is now accepted that in order to have a "source of income" the taxpayer must have a profit or a reasonable expectation of profit. Source of income, thus, is an equivalent term to business: *Dorfman v M.N.R.* [72 DTC 6131], [1972] C.T.C. 151. See also s. 139(1)(*ae*) of the *Income Tax Act* which includes "personal and living expenses" and therefore is not deductible for tax purposes, the expense of properties maintained by the taxpayer for his own use and benefit, and not maintained in connection with a business carried on for profit with a reasonable expectation of profit. If the taxpayer in operating his farm is merely indulging in a hobby, with no reasonable expectation of profit, he is disentitled to claim any deduction at all in respect of expenses incurred.

There has been considerable debate in the literature, and in subsequent court decisions, as to the scope and application of this *dictum*. The only statutory application in the Act would be in relation to paragraph 18(1)(*h*), which states:

> 18(1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
>
> ...

> (*h*) personal or living expenses of the taxpayer, other than travel expenses incurred by the taxpayer while away from home in the course of carrying on the taxpayer's business;

Reasonable expectation of profit arises, then, is included in definition of personal and living expenses in subsection 248(1):

> "personal or living expenses" includes
> (*a*) the expenses of properties maintained by any person for the use or benefit of the taxpayer or any person connected with the taxpayer by blood relationship, marriage or common-law partnership or adoption, and not maintained in connection with a business carried on for profit or with a reasonable expectation of profit,
> (*b*) the expenses, premiums or other costs of a policy of insurance, annuity contract or other like contract if the proceeds of the policy or contract are payable to or for the benefit of the taxpayer or a person connected with the taxpayer by blood relationship, marriage or common-law partnership or adoption, and
> (*c*) expenses of properties maintained by an estate or trust for the benefit of the taxpayer as one of the beneficiaries;

Given this wording, it would seem that the REOP test should not be applied in cases where there is purely a commercial venture, and no personal element is present. This is the interpretation put forward by Mr. Justice Linden in *Tonn v The Queen*, 96 DTC 6001. In *Tonn*, the taxpayer purchased a rental property for $245,000 in 1989 using mostly borrowed funds. While not a sophisticated investor, Mr. Tonn did make income projections based on his understanding of the market, and at the time, Mr. Tonn expected to repay debt such that a profit would be realized beginning in 1992. However, market conditions prevented such a profit from occurring and losses continued. Revenue Canada denied the losses based on the argument that there was no reasonable expectation of profit. In his decision, Mr. Justice Linden stated that the REOP test should be applied "sparingly and with a latitude favouring the taxpayer" when there is no personal or non-business motive to the investment. Thus, he found in favour of the taxpayer, and, at 6015, states

> ...the evidence clearly showed that the taxpayer engaged themselves in a business enterprise and their expectations of profit were not unreasonable in the circumstances. ...No personal benefit accrued to the taxpayers by the rental arrangements. The property was not a vacation site. The house was not used to give free or subsidized housing to relatives or friends. They made an honest error in judgement and lost money instead of earning it. It is not for the department (or the Court) to penalize them for this, using the reasonable expectation of profit test, without giving the enterprise a reasonable length of time to prove itself capable of yielding a profit.

Numerous articles have been written about the REOP test, and the applicability of the *Tonn* decision. Examples of these articles include

J. Bernstein, and S. Doobay, "Selected issues in real estate taxation", *Report of Proceedings of the Fifty-first Tax Conference, 1999 Tax Conference*, (Toronto: Canadian Tax Foundation, 1999), 4:1-33,

Joanne E. Magee, "Real estate rental losses and the application of the reasonable expectation of profit test after the *Tonn* decision," *Canadian Tax Journal*, (Toronto: Canadian Tax Foundation, 1996) v. 44, no. 4, 1150–76,

Earl I. Miller, "Current cases in real estate," *1998 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 1998), 9:1-19,

Brian S. Nichols, "Chants and ritual incantations: Rethinking the reasonable expectation of profit test," *Report of Proceedings of the Forty-Eighth Tax Conference, 1996 Tax Conference* (Toronto: Canadian Tax Foundation, 1997), 28:1-48

Clifford Rand and Susan Thomson, "Reasonable expectation of profit: More variations on a familiar theme," *1999 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 1999), 3:1-17,

Craig C. Sturrock, "Tax shelters—Assessing issues," *1999 British Columbia Tax Conference*, (Vancouver: Canadian Tax Foundation, 1999), 18:1–19, and

David Wentzell, Mary-Ann Haney, Lisa Wong, and Lara Friedlander, "Current cases," *Canadian Tax Journal*, (1997), v. 45, no. 6, 1359–77.

Magee, for example, draws out three aspects of the decision (Magee, 1996, at 1153):

> 1) The decision indicates that when there is no personal or non-business motive apparent, "the test should be applied sparingly and with a latitude favouring the taxpayer, whose business judgement may have been less than competent." In other words, in a purely commercial enterprise, a taxpayer should not be penalized just because he or she made a mistake in judgement about the viability of an enterprise.
>
> 2) The decision also indicates that a sophisticated market analysis is not necessary. ...
>
> 3) The decision says that taxpayers starting up rental operations must be given a reasonable amount of time to prove the viability of the operations before the test can be applied. ...

Based on the *Tonn* decision, among others, it appears that if there is no personal element to the ownership of the rental property, one could avoid having losses denied under the REOP test. However, CCRA continues to challenge the deductibility of losses from rental properties if there does not seem to be a profit-making potential and there has been a long

period of losses incurred. It is interesting to note, however, that the REOP test has never been applied to corporations.

3.3.3 Rules applicable to limited partnerships

Depreciation-based or similar tax shelters, such as residential buildings, films, hotels and nursing homes, have been available in the past. They have been used as a tool of fiscal policy to encourage investment in certain areas by providing a fast write-off. For example, a high CCA rate, or an immediate write-off of a large proportion of an amount invested will reduce after-tax cash outflows in the year of the investment. As extensive use of these shelters is perceived as an abuse of the system by the Department of Finance, the ability to shelter other income with losses created by capital cost allowance has been either eliminated or reduced in effect. This was the case for residential buildings as described in the previous section. On December 1, 1994, the federal government announced further measures with the stated objective of improving the fairness of the tax system and preventing abuses through aggressive tax shelter promotion.

When the residential property is owned through a limited partnership, the losses that can be claimed by a particular partner are limited to the partner's "at risk" amount, which is basically the partner's investment in the partnership. Interpretation bulletin *IT-232R3 Losses — Their Deductibility in the Loss Year or in Other Years* (July 4, 1997) describes the application of the loss limitation rules, as follows:

> 2. A taxpayer's loss from business or property can be a share of a loss of a partnership of which the taxpayer is a member. If the taxpayer is a "limited partner" as defined in subsection 96(2.4), the rules in subsection 96(2.1) can prevent the taxpayer's share of the loss from being fully deductible in the loss year. By virtue of subsection 96(2.1), the portion of a limited partner's share of partnership losses from business (other than a farming business) or property that can be deducted in the loss year is based on the limited partner's "at-risk amount" (which is determined under subsection 96(2.2)) at the end of the fiscal period of the partnership that ends in the year less certain amounts specified in subsection 96(2.1).

Where losses are not deductible in a given year, they can be carried forward under paragraph 111(1)(*e*) and applied towards income from limited partnership interests. Again, the deduction cannot exceed the "at-risk" amount in those years.

3.3.4 Rules applicable to real estate investment trusts

Where the real estate is held by a trust, such as a real estate investment trust (REIT), the same rules apply as those that apply to individuals. Thus, the CCA claims of a REIT would be limited to the amount of income determined prior to the claim for CCA (as described in section 3.2.3, above).

3.4 Goods and Services Tax/Harmonized Sales Tax

The basic system for the Goods and Services Tax/Harmonized Sales Tax (GST/HST) in Canada is described above in 2.3. The GST/HST implications of renting residential property are also discussed in 2.3.2. To summarize, the provision of residential property on a long-term (more than 30 days) basis is an exempt supply for GST/HST under the *Excise Tax Act*. This means that the owner of the rental building is considered to be the "consumer" and pays GST/HST on the purchase of supplies. However, by providing an exempt supply, the landlord does not charge tenants GST/HST, nor is the landlord entitled to an input tax credit on any GST/HST paid to others. The GST/HST paid may be recoverable upon sale of the building, should certain conditions described in section 2.3.2 be met.

On October 4, 2000, proposed amendments to the GST system for residential rental properties was tabled. If passed, a New Residential Rental Property Rebate will be available on qualified purchases after February 27, 2000. The rebate is equal to 2.5% of the cost (36% of the GST paid) for newly-constructed, substantially renovated, or converted long-term residential rental accommodation. The rebate is available for residential units with fair market values up to $450,000.

3.5 Provincial Personal Income Tax

3.5.1 Overview of the rates and structure across Canada

While stable for many years, the provincial individual tax system underwent a significant transformation in 2000. Until 2000, all provinces (except Quebec) and the territories computed income tax as a percentage of basic federal tax. These "tax on tax" systems resulted in little flexibility for the province in setting brackets and the degree of progressivity in the rates. As a result, many provinces introduced surtaxes or low-income tax reductions to increase the progressivity, or flat taxes to decrease the progressivity.

Starting in 2000, five provinces switched to a "tax on income" system, with the other provinces following for 2001. A tax in income allows provinces to set their own brackets, rates and credits, similar to the system that has been used by Quebec for many years. Ultimately, this change should result in a simpler system for a given individual as surtaxes, flat taxes and tax reduction adjustments are rolled into the basic structure. Initially, changes are expected to have little impact on the amount of tax paid by individuals.

The rates applicable to provincial taxable income are summarized in the following table [source: CCH Canadian Limited, *Canadian Income Tax Act with Regulations, 71st Edition* (2000), and *Canadian Tax Letter* (KPMG: November 2000 as updated to January 10, 2001)]. Rates presented are for the year 2001.

Table 4: Provincial Personal Income Tax Rates, 2001

Jurisdiction	Basic Rates and Brackets[1]		Surtaxes		Tax Reduction[2]
	Rate	Bracket	% of tax	On tax above	
British Columbia	19.7 18.7 16.7 11.9 8.4	85,000 70,000 60,970 30,485 0			
Alberta	10.0	0			
Saskatchewan	16.0 13.5 11.5	60,000 30,000 0			
Manitoba	17.5 16.2 10.9	61,090 30,545 0			
Ontario	11.16 9.24 6.20	61,630 30,815 0	20% + 36%	$3,560 $4,491	$9,680 to $12,129
Quebec[3]	25.00 22.50 18.00	52,000 26,000 0			
New Brunswick	16.52 14.82 9.68	59,181 29,591 0	8%	$13,500	
Nova Scotia	16.67 14.95 9.77	59,181 29,591 0	10%	$10,000	$13,703 to $21,000
Prince Edward Island	16.7 13.8 9.8	61,510 30,755 0	10%	$5,200	$9,789 to $20,000

Table 4 continued...

Table 4: Provincial Personal Income Tax Rates, 2001 (continued)					
Jurisdiction	Basic Rates and Brackets[1]		Surtaxes		Tax Reduction[2]
	Rate	Bracket	% of tax	On tax above	
Newfoundland	18.02 16.16 10.57	59,181 29,591 0	9%	$7,032	
Yukon	14.21 12.74 10.78 7.84	100,000 61,510 30,755 0	5%	$6,000	
Northwest Territories	13.05 11.70 9.90 7.20	100,000 61,510 30,755 0			
Nunavut	13.05 11.70 9.90 7.20	100,000 61,510 30,755 0			

[1] All provinces use a "tax on income" that sets rates independently of federal rates. "Tax on tax" continues to be used by the territories; this approach sets rates as the fixed percentage of federal tax, so the rates shown depend on federal rates. The bracket value shown is the lower threshold at which the rate is applied.

[2] Provincial tax reductions eliminate provincial taxes up to at least the first income figure and reduce provincial taxes at least throughout the range indicated.

[3] Residents of Quebec pay federal tax rates that are 83.5% of the federal rates.

3.5.2 Rules relating to providers of rental housing

There are no specific incentives or disincentives set out for owners of residential rental property. Under either the tax on income or the tax on tax systems, the definitions of income follow those determined for the federal income tax system. Thus, CCA limitations or the denial of losses resulting from the application of the reasonable expectation of profit test would hold equally for provincial income tax purposes.

3.6 Property Taxes

The major source of tax revenue for municipal governments is property taxes. As with many taxes, the basic calculation is a tax base times a tax rate. For property taxes, the base is some amount relating to the value of the property, and the rate is usually referred to as a "mill" rate, which is the amount of tax owed on each $1,000 of assessed value. Alternatively, rates are also states as the percentage of assessed value.

Overviews of the property value calculations are described below for selected cities across Canada. However, provinces specify the manner in which the municipalities determine the value of the property; therefore, these summaries are more broadly applicable. For example, the Current Value Assessment system described for Toronto would apply to all municipalities in Ontario. Many have commented on the fact that while all municipalities use words like "market" or "current" value as the assessment base, the assessment practices across jurisdictions and types of properties have lead to considerable variation in the degree to which assessed values actually reflect estimated sale value of a given property. Following the descriptions of the individual jurisdictions, once cross-jurisdiction comparison is presented. Note that rates for 2001 were not generally available at the time of publication, so 2000 rates are presented.

3.6.1 Vancouver

In British Columbia, property assessments reflect market values effective July 1 of the preceding year. In general terms, market value is the price expected if a reasonable amount of time is allowed to find a purchaser and if both seller and prospective buyer are fully informed. For assessment purposes in British Columbia, market value is the most probable price that an unencumbered property would sell for on the open market on July 1.

In Vancouver, property tax on residential property is assessed at a rate of 0.628192% of assessed value.

3.6.2 Calgary

Calgary uses a market value assessment system where market values are determined based on estimated values at July 1 of the prior year. The property tax rate in Calgary is 0.96924% of assessed value for residential properties. This rate is consistent with a property tax listed that was consulted. A three-bedroom home listing for $174,900 had 1999 property taxes of $1,562, or 0.893% of "market" value.

3.6.3 Winnipeg

Winnipeg uses a market value assessment system where market values are determined based on estimated values at July 1 of the prior year. The assessed value is weighted as follows:

CLASS	DESCRIPTION	PORTIONED VALUE
Residential 1	Single Family Residential Dwelling	45%
Residential 2	More Than 4 Residential Units	49%
Residential 3	Condominium	43%
Farm Property	Self - Explanatory	30%
Institutional	Church, Hospitals, Public Schools	65%
Pipeline	Self - Explanatory	50%
Railway	Self - Explanatory	25%
Golf Course	Self - Explanatory	9.5%
Other	Everything not Listed Above	65%

The mill rate is levied against the portioned assessable property. The mill rate is the same for single unit and multiple unit residential properties. The mill rate for 2000 is as follows:

Municipal	3.2809%
Provincial Education Support Levy	0.7898
School Division (Composite)*	2.2531
Total	6.3230%

* There are 12 school divisions each with their own budget and mill rate. The composite mill rate reflects a common rate by using the sum of all school division budgets.

Therefore, for a residential 2 (more than 4 residential units) building, the tax rate is 6.323% times 49% of assessed value, or 3.09827% of assessed value, and for a residential 1 home, the rate is 2.84535%. While this seems high, when a house listing was consulted, it was found that a 2 year old three bedroom home listing for $159,900 has annual property taxes of $4,336, or 2.7117% of listed (market) value.

3.6.4 Toronto

Toronto uses a current value assessment system where values are determined based on a comprehensive re-assessment that occurs periodically. For 2000 tax computations, the 1996 estimated market values are used; however, due to extremely large adjustments that were required when this reform was implemented (the city traditionally has used historical values), the upward adjustment was capped and increases phased in over three years. The next reassessment is scheduled for 2001 and will be based on 1999 values but the capping of adjustments may continue to result in assessed values that differ significantly from market values (i.e., estimated values that would result from a willing sale).

The property tax rate in Toronto is 1.213702% of assessed value for residential properties. However, given the somewhat dated value on which the assessment is based (e.g., 1996 values rather than 1999 values in the other cities and increases relative to historical values

capped), the rates are not strictly comparable. The comparability may be improved following the 2001 reassessment.

3.6.5 Montréal

The City of Montréal applies a mill rate on the total value of all non-exempt real property within its jurisdiction. The general real estate tax rate is 2.4109%. A 1998 report by The Canadian Research Committee on Taxation on property taxes in Montreal states "The valuations for tax purposes are, however, relatively current and in this sense Montréal is well ahead of other municipalities in Canada such as Toronto." However, discussions with some real estate brokers indicate that it is common for assessed values in places like Brossard, a suburb on the south shore, to be 20% to 25% below sales prices.

3.6.6 Halifax

Halifax, like the other cities, bases its property taxes on the assessed value of the property multiplied by the applicable rate. The assessed value is the market value of the property at a base date as determined by the Department of Housing and Municipal Affairs of the Government of Nova Scotia. The year 2000 property Assessment is based on the real estate market conditions as of January 1, 1998 and the physical condition of the property as of December 1, 1999. The rate applied in 2000 is 1.4114% of assessed value.

3.6.7 Comparison of Property Taxes

Due to the differences in property tax assessment practices, there can be considerable variation in the applicability of the statutory property tax rates across cities, even within a given province (for example, the capping of adjustments in Toronto is not true in all Ontario cities).

4 Taxation on Housing Occupants

4.1 Overview

Housing occupants are individuals who either own their houses or units within a multiple unit complex, or rent one of these. In general, there are very few income tax provisions that specifically relate to the occupants of housing, per se. Similarly, there are no noteworthy provisions with respect to GST/HST, since all forms of accommodation are exempt, except the purchase of new, or substantially renovated houses, as discussed in section 2.3.1. A general discussion of the personal income tax system in Canada is found in sections 3.3.1 and 3.5.1. Property taxes are discussed in section 3.6. The only significant provisions are the principal residence exemption and property tax credits offered by the Manitoba and Ontario provincial governments. These are discussed below.

4.2 Principal Residence Exemption

Gains that occur on the sale of a "residence" can be exempt, wholly or partially, by designating the home as the taxpayer's principal residence for certain specific years. A "principal residence" defined in section 54 of the Act is virtually any housing unit or right to such a unit owned by the taxpayer either by himself or herself or jointly and ordinarily inhabited by the taxpayer, the taxpayer's spouse or former spouse, or the taxpayer's child at any time in the taxation year. Note that CCRA, in paragraphs 3 and 5 of Interpretation Bulletin *IT-120R5 Principal Residence* (November 30, 1999), states

> 3. The following are the types of property that can qualify as a "principal residence":
> - a housing unit, which includes:
> – a house,
> – an apartment or unit in a duplex, apartment building or condominium,
> – a cottage,
> – a mobile home,
> – a trailer, or
> – a houseboat;
> - a leasehold interest in a housing unit; or
> - a share of the capital stock of a co-operative housing corporation, if such share is acquired for the sole purpose of obtaining the right to inhabit a housing unit owned by that corporation. The term "co-operative housing

> corporation" means an association, incorporated subject to the terms and conditions of the legislation governing such incorporation, and formed and operated for the purpose of providing its members with the right to inhabit, by reason of ownership of shares therein, a housing unit owned by the corporation.

Land on which a housing unit is situated can qualify as part of a principal residence, subject to certain restrictions

5. Another requirement is that the housing unit must be "ordinarily inhabited" in the year by the taxpayer or by his or her spouse, former spouse or child.

The question of whether a housing unit is ordinarily inhabited in the year by a person must be resolved on the basis of the facts in each particular case. Even if a person inhabits a housing unit only for a short period of time in the year, this is sufficient for the housing unit to be considered "ordinarily inhabited in the year" by that person. For example, even if a person disposes of his or her residence early in the year or acquires it late in the year, the housing unit can be considered to be ordinarily inhabited in the year by that person by virtue of his or her living in it in the year before such sale or after such acquisition, as the case may be. Or, for example, a seasonal residence can be considered to be ordinarily inhabited in the year by a person who occupies it only during his or her vacation, provided that the main reason for owning the property is not to gain or produce income. With regard to the latter stipulation, a person receiving only incidental rental income from a seasonal residence is not considered to own the property mainly for the purpose of gaining or producing income.

If the housing unit is not ordinarily inhabited in the year by any of the above-mentioned persons, it is still possible for the property (as described in ¶3) to be considered to be the taxpayer's "principal residence" for the year, by means of an election under subsection 45(2) or (3)

To be a principal residence, the property must be designated as such in the year of disposal. The exemption applies not only to the building but also up to one-half hectare of subjacent land. Land in excess of one-half hectare must be shown to be necessary to the taxpayer's use and enjoyment to be eligible for this exemption.

A taxpayer owning more than one residence can designate only one of his or her residences for a given year. This is done at the time when an actual or deemed disposition is reported. Paragraph 40(2)(*b*) sets out the formula for the exemption.

> 40(2) Notwithstanding subsection (1),
>
> ...
>
> (*b*) where the taxpayer is an individual, the taxpayer's gain for a taxation year from the disposition of a property that was the taxpayer's principal residence at any time after the date (in this section referred to as the "acquisition date") that is the later of December 31, 1971 and the day on which the taxpayer last acquired or reacquired it, as the case may be, is the amount determined by the formula
>
> $$A - (A \times B/C) - D$$

where

A is the amount that would, if this Act were read without reference to this paragraph and subsections 110.6(19) and (21), be the taxpayer's gain therefrom for the year,

B is one plus the number of taxation years that end after the acquisition date for which the property was the taxpayer's principal residence and during which the taxpayer was resident in Canada,

C is the number of taxation years that end after the acquisition date during which the taxpayer owned the property whether jointly with another person or otherwise, and

D is

(i) where the acquisition date is before February 23, 1994 and the taxpayer or a spouse or common-law partner of the taxpayer elected under subsection 110.6(19) in respect of the property or an interest therein that was owned, immediately before the disposition, by the taxpayer, 4/3 of the lesser of

(A) the total of all amounts each of which is the taxable capital gain of the taxpayer or of a spouse or common-law partner of the taxpayer that would have resulted from an election by the taxpayer or spouse or common-law partner under subsection 110.6(19) in respect of the property or interest if

(I) this Act were read without reference to subsection 110.6(20), and

(II) the amount designated in the election were equal to the amount, if any, by which the fair market value of the property or interest at the end of February 22, 1994 exceeds the amount determined by the formula

$$E - 1.1F$$

where

E is the amount designated in the election that was made in respect of the property or interest, and

F is the fair market value of the property or interest at the end of February 22, 1994, and

(B) the total of all amounts each of which is the taxable capital gain of the taxpayer or of a spouse or common-law partner of the taxpayer that would have resulted from an election that was made under subsection 110.6(19) in respect of the property or interest if the property were the principal residence of neither the taxpayer nor the spouse or common-law partner for each particular taxation year unless the property was designated, in a return of income for the taxation year that includes February 22, 1994 or for a preceding taxation year, to be the principal residence of either of them for the particular taxation year, and

(ii) in any other case, zero;

Thus, generally, for years that are designated, the exemption is equal to

$$\frac{1 + \text{number of years designated}}{\text{number of years owned}} \times \text{gain}$$

The definitions and provisions result in the following features to note: only one housing unit can be designated as a principal residence, after 1981, per family as defined in the definition of principal residence in section 54; years in the numerator and denominator refer to years after 1971; the taxpayer must be resident of Canada; the formula in the Act contains a factor ("D") that reduces the gain by an amount based on the election made in 1994 to utilize the general capital gains deduction of $100,000 (eliminated February 22, 1994); and deemed dispositions, discussed below, affect the formula. Since families can only designate one housing unit as the principal residence for any particular year, the 1 + in the numerator of the fraction protects one housing unit in a year in which the family sells on unit and purchases another, but can only designate one of them in that year.

Where an individual has a residence that is occupied by the owner during some period, or periods, of time and used as a rental unit for another period of time, there are elections under subsections 45(2) and (3) that may be used. These elections permit the property to designated as a principal residence for up to four years (unlimited if the conditions of section 54.1 are met) of the period during which the taxpayer used the property as a rental property. The elections cannot be made if CCA is claimed on the property. In addition, the 45(2) election, which applies only if the first use of the property was as an owner-occupied residence, allows the change in the use of the property to not be treated as a deemed disposition, as would normally be the case under paragraph 45(1)(*a*).

4.3 Provincial Personal Income Tax Credits on Housing Ownership and Rental

4.3.1 Manitoba

Manitoba provides a refundable property tax credit. This credit has two components. The first is a refundable residential component. The "dwelling unit cost" on which the credit is based, is equal to property taxes paid and/or 20% of rental payments that exclude meals and board components. In addition to the general credit level available to all, there is an enhanced credit for seniors (those over the age of 65) and families with both income less than $23,800 and who are over age 55. The general credit is computed as follows

Lesser of			
(a) the dwelling unit cost			$ xxx
minus			(_250)
			$ xxx
(b) Greater of			
(i) basic amount	$ 525		
less 1% of family income	(_xxx)	$ xxx	
(ii)		$ 250	
Greater of (i) and (ii)			$ xxx

For dwelling costs sufficiently high, the credit equals $525 less 1% of family income. For a family with income above $27,500, the credit will equal $250.

4.3.2 Ontario

The Ontario property tax credit is based on the taxpayer's occupancy cost, which is roughly equivalent to the dwelling unit cost in Manitoba. The credit is equal to the occupancy cost to a maximum of $250 plus 10% of the occupancy cost. This base credit is reduced by 2% of family income in excess of $4,000. For seniors, the base may be higher.

5 Studying The Appropriateness of the Taxation of Rental Housing in Canada

5.1 Overview

The above sections compile the taxation provisions that relate to the builders of residential property, the providers of rental property (who may be builders as well), and the occupants of residential property. There are various incentives and disincentives built into the federal, provincial, and municipal tax systems that require analysis. Many of these provisions have been added, or modified, over time without a published comprehensive review of their total impact. This section of the report will describe how a research on the appropriateness of these rules could be conducted, and will focus specifically on rental property providers.

An example of a possible anomaly that has entered the taxation of providers of rental property is the CCA limitation that some organizations face. Specifically, some providers of rental properties are limited in the amount of CCA that can be claimed on rental properties (i.e., they cannot create a loss with CCA deductions), whereas corporations that engage in rental activities as their principal business do not have such limitations. What is the effect of this? How prevalent are rental losses among individuals or corporations? Do these rules reduce the amount of rental housing? Is it fair for two owners to be treated differently simply because one is a corporation meeting certain arbitrary criteria?

The analysis in stage 2 will focus on section 3 of the rules described above. Focusing on one economic activity (providing rental housing) allows the analysis to compare the taxation across forms of organization. This horizontal analysis will focus on several issues: housing affordability, tax fairness and other goals of taxation, and industry stimulus. It should be noted that the analysis could also be conducted vertically; that is, focus on the full life of building rental housing, owning rental housing, and leasing rental housing from others; or similar cycle for owner-occupied housing.

5.2 Summary of Evaluation Criteria

When analyzing taxation policy, the first necessary step is to establish the criteria against which the policies are to be assessed. A review of commentators of taxation policy reveals a number of lists of both characteristics of a "good" taxation system, and the objectives of the taxation system. For example, a lengthy list is found in a book by Gorman.[2] This publication lists fourteen "principles of a normative taxation system" (Gorman, p. 40). These fourteen are efficiency, equity, ability to pay, simplicity, neutrality, flexibility, certainty and predictability, taxpayer awareness and acceptance, low administrative and compliance costs, integration, international harmonization, non-arbitrariness, relief from transitional problems, and openness. Equity is further segmented into horizontal and vertical equity. Similarly, ability to pay encompasses several dimensions such as income, personal expenditures on consumer goods and services, and personal net wealth over time.

A brief summary of these principles, based on Gorman (pp. 40–49), is as follows. This is a list of fourteen principles and is very comprehensive. It should be kept in mind that any particular analysis typically considers only a subset of the most applicable and most important of these principles.

Efficiency. This principle includes both the notions of (1) does the tax provision achieve its objectives, and at what tax revenue cost, and (2) how much social of economic cost (or deadweight loss to use the economic term) results from the changes in choices resulting from the tax provision, relative to the taxes raised.

Equity. This principle is also called fairness. Horizontal equity implies that two individuals with similar ability to pay tax, or who are in similar situations, should pay the same amount of tax. It is also possible to interpret this principle to suggest that taxpayers in different positions can or should be treated differently. Vertical equity suggests that

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[2] F. Barry Gorman, *Canadian Income Taxation: Policy and Practice.* Scarborough: Carswell Thomson Professional Publishing, 1999.

individuals with greater ability (more income or wealth) should pay disproportionately more tax (e.g., vertical equity implies a progressive tax system).

Ability to pay. This principal is really part of equity as it forms the basis of some horizontal and vertical equity considerations. Essentially, ability to pay tries to assess the individual's or family's well being, and the relative sacrifice necessary to pay a certain amount of tax.

Simplicity. A tax system is simple if taxpayers have little difficulty in understanding and complying with the law.

Neutrality. Neutrality is a principle that requires the tax system to avoid distorting investment and consumption decisions of the taxpayer. Whenever the tax system is used to encourage or discourage an investment, expenditure or income generating activity, neutrality is decreased.

Flexibility. Since economic trends and taxpayer responses are often uncertain, it is desirable for the system to be flexible, or adaptable, to changes without requiring a change in the law.

Certainty and Predictability. This principle suggests that the tax consequences of a particular transaction or decision would be known at the time of the transaction. The taxpayer would be able to determine with certainty the base, rate, timing and method of tax payments in advance of the transaction.

Taxpayer awareness and acceptance. According to this principle, taxpayers are aware of the tax provisions that affect them, in detail, to allow them to comply with the system. In addition, taxpayers accept the provisions and agree to pay the tax that they owe.

Low administrative and compliance costs. The costs borne by the government (administrative costs) and those borne by the taxpayer (compliance costs) to satisfy the needs of the tax system should be as low as possible. These costs include the costs of non-compliance (i.e., the underground economy).

Integration. In a fully integrated tax system, the total tax paid by an individual is the same whether the economic activity is engaged through a corporation, or by the individual directly. In other words, integration is neutrality with respect to organizational form.

International harmonization. Having a taxation system that is consistent with major trading partners is important to maintain appropriate balance of capital flows and immigration/ emigration. International harmonization also aids in the appropriate taxation of international business.

Non-arbitrariness. In an ideal taxation system, the tax authorities would not be able to apply discretion to the taxpayer's situation: the Act would clearly specify the tax consequences of a transaction.

Relief from transitional problems. As new provisions are enacted, economic distortions would not adversely affect taxpayers. One application of this principle would be that decisions made prior to the new rules should be taxed under the old rules if the old rules were more favourable to the taxpayer.

Openness. This principle encompasses the visibility of the tax provisions. Taxes that are hidden or indirect generally violate this principle.

While each of these fourteen principles is important, these principles are often in conflict with one another. For example, achieving equity often leads to additional complexity. Also, the taxation system is often used to achieve other economic or social objectives, such as encouraging economic growth; however, these efforts will often fail to achieve several of the fourteen principles, such as neutrality. Given these trade-offs, the principles are often prioritized and the priorities seem to change over time as political and economic considerations change.

Overall, the more important principles, based on observation of legislation and discussions in budget speeches and documents, seem to be equity, efficiency, and neutrality.

However, these are frequently tempered by low administrative and compliance costs, certainty and predictability, and to some degree simplicity.

With these principles of a "good" tax system in mind, taxation policy then sets out to achieve certain objectives or goals. Obviously, an important goal of the taxation system is to raise revenue needed for direct government expenditures. However, many other objectives are also implied by either particular provisions, or by the system as a whole. For example, many provisions are intended to redistribute economic resources from those who are more well off, to those who are less fortunate. These redistributive measures are designed to achieve a greater degree of social justice across the economy. A third objective is to encourage certain "desirable" behaviours or discourage "undesirable" behaviours. Another dimension of this goal is to raise additional revenues needed to pay for the social or economic costs created by these undesirable behaviours. There are many other objectives that particular provisions are meant to achieve, which may include specific economic, social or political purposes.

5.3 Research Questions

An analysis of the taxation of rental properties and their owners should consider those tax policy principles and goals that are most relevant. For example, equity will be an important consideration whereas international harmonization will likely be of little concern. The objective of the tax system relating to rental housing may also be an important consideration. Is the more important goal to encourage additional rental housing or to avoid reducing the redistribution of wealth from wealthier to poorer individuals?

Specific provisions that relate to the provision of rental housing that could be analyzed include construction being excluded from "manufacturing or processing," capitalization of land carrying costs, residential property as GST exempt, the CCA limitation for non-PBCs, and the reasonable expectation of profit test. Another possible topic is the application of

GAAP in the construction and rental industries and the impact of this application on tax payments.

A more difficult, but also important, issue that could be addressed is housing affordability, particularly for low to middle income individuals and families. Possible issues include the following. Who (e.g., individuals, small corporations, or large corporations) provides the housing to low and middle income individuals? Does the tax system presently affect housing affordability (i.e., is the tax system neutral). And, if the system is not neutral, is the overall effect to make rental housing more affordable or less affordable?

5.4 Research Approaches

Tax policy research entails two primary methodologies, with some research papers incorporating both types. These methodologies are analytical and empirical. Analytical research employs mathematical models to analyze, in theory, the effects of a particular taxation policy. Empirical analyses use data to test a hypothesis related to a particular issue, or explore the effects of a particular tax provision. When exploring the actual (in contrast to theoretical) implications of taxation in the economy, some form of data analysis would seem to be helpful. Specific examples of tax policy research follow.

A paper by Austin[3] analyzes the tax provisions designed to assist retirement savings. This paper evaluates the current system against the criteria of (1) do the policies meet their objective, (2) is the system efficient (or more specifically, do the current rules minimize loss of government revenues while meeting their objective), and (3) is the system fair (equitable)? The evaluation of the tax system against these criteria involves a combination of application of the normative principles and goals, compilation of evidence from other articles and publications (i.e., so-called "secondary" evidence), and some very limited analysis of

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[3] Barbara Austin, "Policies, preferences and perversions in the tax-assisted retirement savings system," *McGill Law Journal* (June 1996), pp. 571–594.

available Statistics Canada data. Following the analysis, several alternative systems are suggested and discussed.

Another paper on a similar topic is by Mintz and Wilson.[4] This paper evaluates the provision of tax relief for both public and private retirement savings vehicles. Criteria used include the desired redistribution of wealth, horizontal and vertical equity, the impact of taxation on the decisions around retirement, and simplicity. Unlike Austin, this paper provides fairly extensive tabulations of data, both from sources like Statistics Canada and from the authors' own calculations based on primary, publicly-available data. The authors then provide an analysis of the data. Finally, like Austin, the authors present proposals for the reform of the system based on their analysis.

A paper prepared for the Technical Committee on Business Taxation (Department of Finance) by Jog and Tang[5] provides more rigorous example of an empirical tax policy analysis. Rather than analyzing a specific provision in detail, this paper explores the effect of overall tax rates on the use of debt by Canadian-based multinational corporations and U.S.-based multinational corporations with operations in Canada. The stated purpose (at page 2) of the research is "to investigate whether the changes in the relative tax rates between the United States and Canada had an impact on debt levels of Canadian subsidiaries of foreign multinationals as well as Canadian multinationals." The purpose of this analysis is to determine the impact on revenue from possible shifts in debt use.

To conduct this analysis, the authors obtained private data from Revenue Canada through a request of the Department of Finance. This company-level longitudinal data allowed powerful regression tests to be conducted that provide persuasive evidence that debt levels

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[4] Jack Mintz and Thomas Wilson, "Private provision of retirement income: Tax policy issues," in Keith Banting and Robin Boadway (eds.), *Reform of Retirement Income Policy* (School of Policy Studies, Queens University, 1997), pp. 209–238.

[5] Vijay Jog and Jianmin Tang, "Tax reform, debt shifting and corporate tax revenues: Multinational corporations in Canada," Working Paper 97–14, Ottawa: Technical Committee on Business Taxation, Department of Finance (1998).

have responded to the relative difference in tax rates between the United States and Canada over time. Estimates of the regression model also permit a rough calculation of the effect of a future change in tax rates. They find that a decrease in the Canadian tax rates will decrease interest charges, but the additional tax revenue from lower interest deductions does not fully offset the revenue lost from the lower tax rate.

In summary, the general pattern is to discuss the economic issue, describe the current rules and economic environment, provide some evidence relating to the workings of the rules—either from other's work or through primary data collection and analysis, and then either provide proposals for reform or suggest implications of possible changes. Note that this is also the general approach followed by the Carter Commission report;[6] however, this report is much lengthier. The major differences across extant research seems to be, firstly, the choice among the possible criteria that the researchers choose to evaluate the policies, and secondly (and more importantly), the degree of primary data collection and analysis done by the researcher, versus the use of secondary data sources (i.e., appealing to data analyses done by others).

It is our preference to engage in as much primary data collection and analysis as possible. By using others' analyses, we are limited in our ability to explore the issues from different perspectives. Additionally, though our search has not been exhaustive, we have not yet been able to locate any studies that explore the tax provisions of interest relating to the rental housing market in Canada. Thus, our ability to use the data collection and analysis of others may be severely limited. Additionally, presenting data on the prevalence, importance, and/or magnitude of the tax provisions would be extremely helpful as a contribution to any proposed reforms.

Collecting this information may simply be a synthesis to the extent that these data are currently available at CMHC or through Statistics Canada. For data not currently available,

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[6] Canada, *Royal Commission on Taxation, Report.* Ottawa: Queen's Printer (1966).

one method of potentially obtaining needed data is to request specific data, or analyses from Canada Customs and Revenue Agency, or Statistics Canada. Other sources of information will also be sought as necessary.

With the analysis of the data available, the research will become a review of the various provisions discussed above against the criteria of the salient principles of tax policy. These principles include equity, neutrality, and efficiency. In addition, the relevant goals of the policies such as encouraging the growth of the rental housing stock and achieving affordable housing for low-income families will also be a basis for the analysis.

6 Summary

6.1 Taxation on Producers of Housing

Corporations active in the production of housing, either as owner-occupied or rental housing, face corporate income taxes at the federal and provincial levels. Smaller Canadian-Controlled Private Corporations receive reduced rates from the federal government and several provincial governments. GST and HST apply to the production and sale of new single and multi-unit housing; however, the rental of these to individuals for residential use is exempt from GST and HST. For provinces with a retail sales tax, residential housing is generally exempt. Finally, a capital tax is charged by several provinces and also by the federal government as an alternative minimum tax to the corporate income tax.

For income tax purposes, a distinction is made between what are called Principal Business Corporations (PBCs), corporations whose principal business is a combination of production, sale and leasing of property, and other corporations. For PBCs, costs relating to the carrying of raw land (i.e., interest and property taxes) are immediately deductible, whereas for non-PBCs, these costs can only be deducted to the extent of any rental revenue received from the land.

During the period of construction, soft costs including interest that relate to the new building must be capitalized into the cost of the building until it is completed, or at least reached a level of use of 90%. Claiming of CCA must also wait until the building is completed and put into its intended use.

6.2 Taxation on Providers of Rental Housing

Corporations, individuals and other organizational forms such as limited partnerships and trusts provide rental housing. Generally, rules and rates follow other forms of business and property income calculation for income tax purposes. Residential rental activities are exempt from GST/HST and from sales taxes, making the *owner* of these properties the "consumer" for these consumption taxes. A significant local tax is the municipal property tax. Tax rates and assessment practices vary across provinces and municipalities making it difficult to determine the relative differences in these taxes across jurisdictions and across housing type.

Important rules for some providers of rental housing are the CCA limitation rules that apply to all owners except PBCs. For those limited by these rules, no losses can be created by CCA. A second practice important to individuals owning rental properties is the "reasonable expectation of profit" test that has been applied by CCRA and enforced in some cases by the courts. This test is used frequently to assess taxpayers when there is a sustained period of losses; and when applied, this test prevents the owner from claiming any losses that arise from rental properties.

6.3 Taxation on Housing Occupants

Property taxes are the major direct tax on housing owner-occupants, and renters to the extent that their rent reflects property tax costs of the building owner. For income taxes, an owner-occupant is entitled to a principal residence exemption that shields all gains from capital gains taxation. Manitoba and Ontario also provide a small tax credit to residents, though the Ontario credit is phased out for higher-income individuals.

6.4 Further Analysis

Given the many rules that have slowly evolved over time in the taxation of real estate in Canada, it may be time to perform a review of some aspects of the taxation system to determine if, in total, it is providing the desired incentives. The criteria that could be used plus a review of selected articles demonstrate the common methodologies that can be used to perform this type of analysis.

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